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## THE TROUBLED MARRIAGE OF RETIREMENT SECURITY AND TAX POLICIES

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INTRODUCTION

Complaints about the unfairness of the social security pension system have become common. There are many variations on this theme, but the core of the unfairness claim is the failure of social security pensions to replicate the payment and benefit distribution structure of an “actuarially fair” insurance scheme. Middle- and high-income individuals would do better in such a private system. In this Article, I will argue that there is, indeed, unfairness in the social security tax and payments scheme, but that it is very nearly the opposite of the problem identified by private insurance advocates. Viewed from the perspective of overall retirement security, particularly when one considers how income tax expenditures (the revenue losses attributable to special federal income tax provisions) now shape that policy, the real fairness problems with social security are the regressivity of its tax structure and its modest capacity to maintain the standard of living of low and moderate wage earners. Moreover, an integrated view of both social security and income tax expenditures for employer-provided pensions and individual retirement savings reveals serious problems of relying on these generally applauded tax expenditures to implement national retirement security policies. At the same time, these tax expenditure provisions may place important tax policy concerns at risk.

Commentators typically describe a tripartite system that enables and encourages the provision of income security for individuals in the

years following their retirement from the workforce: Social Security, employer-provided pensions, and individual savings. After acknowledging the existence of these three components of our national retirement security program, however, analysts routinely focus exclusively on one or another aspect. To a large extent, this compartmentalization of analysis of the retirement security issue reflects a compartmentalization of expertise. For example, there are experts on federal taxes other than social security, experts on federal spending other than social security, experts on Social Security, and experts on private pensions. These experts rarely seem to communicate with one another and, indeed, seem often to be operating with independent and often unrelated criteria for their evaluations and policy recommendations. In this Article, I treat all three elements—Social Security, employer-provided pensions, and individual savings—as separate parts of an overall effort to provide a coherent and unified national retirement security policy.

An effort to analyze these three aspects of retirement security policy as a unified system is inherently complex. It is difficult to conceive of a wider spectrum of public policy mechanisms intended to implement a single goal. At one extreme is Social Security, a mandatory national public program financed by the federal government's power to tax, fulfilled by the government's power to spend,<sup>1</sup> and explicitly redistributive in both purpose and effect—redistributional both across generations and within the same generation.<sup>2</sup> At the opposite extreme is

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<sup>1</sup> See generally *Helvering v. Davis*, 301 U.S. 619 (1937) (upholding the constitutionality of the old-age benefit features of the Social Security Act); *Steward Mach. Co. v. Davis*, 301 U.S. 548 (1937) (upholding the constitutionality of the unemployment compensation features of the Social Security Act); Cohen, *The Development of the Social Security Act of 1935: Reflections Some Fifty Years Later*, 68 U. MINN. L. REV. 379, 399-403 (1983) (discussing the historical context of the two foregoing *Davis* opinions).

<sup>2</sup> The distribution of social security benefits was intended from the outset to provide a minimum level of retirement security for all workers. See Musgrave, *A Reappraisal of Social Security Financing*, in *SOCIAL SECURITY FINANCING* 89, 97, 106-07 (F. Skidmore ed. 1981). Thus, Social Security provides proportionately larger benefits to lower-paid workers than to higher-paid workers. See N. Altman Lupu, *Rethinking Retirement Income Policies: Nondiscrimination, Integration and the Quest for Worker Security* 52 (1986) (forthcoming in 42 *TAX L. REV.* (Spring 1987)). The pay-as-you-go financing mechanism of Social Security creates a redistribution of income from workers currently paying social security payroll taxes to retired workers. This financing method, coupled with rapidly increasing payroll tax rates, is viewed by many current workers as a wealth transfer to the older population. See A. Munnell, *The Current Status of Social Security Financing* 2 (rev. ed. Dec. 19, 1985) (unpublished manuscript presented at Yale University Institution for Social and Policy Studies Forum on the Future of Social Security); J. Tobin, *The Future of Social Security: One Economist's Assessment* 4 (Feb. 1985) (forthcoming as chapter 2 of *SOCIAL SECURITY IN CONTEMPORARY AMERICAN POLITICS* (T. Marmor & J. Mashaw eds. 1987)); Boskin, Kotlikoff, Puffert, & Shoven, *Social Security: A Financial Appraisal Across and*

reliance on individual savings as a source of retirement security, a predominantly private program, with the individual (or the family) composing the relevant unit. Individual retirement savings are often regarded as largely unaffected by direct government action, although federal tax policy has played an important role, sometimes encouraging and sometimes inhibiting such savings.<sup>3</sup> Bridging these two public/private extremes are employer-provided pensions, voluntary private programs encouraged through income tax reductions, regulated by government, both directly and as to the many requirements that must be met to qualify for tax benefits,<sup>4</sup> and backed, at least in a limited way, by an insurance system of national scope.<sup>5</sup> Taken together, then, these three retirement security sources reflect a full spectrum of policy initiatives: a federal social program for all Americans, an individualistic program dependent principally upon familial self-reliance, and a pluralistic communitarian program involving both employers and employees.

This Article concentrates on equitable and distributional aspects of the retirement security problem, although the unified view taken here seems essential to an adequate assessment of the fairness or efficacy either of the three components taken together or of any one of the three. Moreover, because tax legislation serves as the dominant public mechanism for implementing national retirement policy, whether through funding Social Security via the payroll tax or providing tax incentives for both private pensions and individual savings, a unified view of retirement security policy highlights interrelationships, confluences, and potential conflicts between retirement security and tax policy concerns.

This Article examines these interrelationships and advances a variety of policy recommendations. Part I lays the groundwork for a national retirement security policy by describing the goals of such a program and, in particular, the critical role of federal tax policy in implementing our retirement security program. Parts II through IV then provide, respectively, analyses of the payroll tax, employer-provided pensions, and individual savings for retirement, discussing each in relation to a unified national retirement security policy. The Article

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*Within Generations*, 40 NAT'L TAX J. 19, 22 (1987). This Article does not address concerns regarding the intergenerational distribution of Social Security; Social Security is only one component of the retirement equity problem.

<sup>3</sup> See, e.g., PRESIDENT'S COMMISSION ON PENSION POLICY, COMING OF AGE: TOWARD A NATIONAL RETIREMENT INCOME POLICY 44 (1981) [hereinafter COMING OF AGE] ("Tax policy has encouraged individual retirement savings only to a limited extent.").

<sup>4</sup> See, e.g., A. MUNNELL, THE ECONOMICS OF PRIVATE PENSIONS 30-61 (1982) (discussing the relationship between income tax incentives and private pension plans).

<sup>5</sup> See *infra* notes 111-15 and accompanying text.

concludes by suggesting possible directions for a more fair retirement program.

## I. A NATIONAL RETIREMENT SECURITY POLICY

### A. Goals

At the outset one should describe the goals of retirement security policy in order to measure the success or failure of the current mix of public and private programs and to determine whether these programs comprise a coherent whole in addressing the retirement security problem. The shortfall in income upon retirement is lost income from labor.<sup>6</sup> Thus, while there are no doubt disagreements at the margin, replacement of some significant portion of preretirement wages must be the fundamental goal of retirement security policy. Retirement security also implies that the replacement of preretirement labor income will ensure for the retiree the maintenance of an adequate retirement income that will both protect the elderly from widespread poverty<sup>7</sup> and generally ensure against an abrupt decline in a retiree's lifestyle.<sup>8</sup>

Further refinement of this goal, for example by specifying an appropriate percentage of wages that should be replaced for various categories of earners upon retirement, no doubt will prove more controversial. From a public policy perspective, a higher percentage of preretirement wages must be replaced for low- and moderate-income workers even though some percentage of income should be replaced for all workers. Thus, a national retirement policy that includes both a basic adequacy of income component and a lifestyle maintenance concern must, to some degree, be redistributive in overall effect. It would be indefensible consciously to construct a national retirement security program that replaces a greater percentage of wages for high- than for moderate- and low-income earners. At the limit, of course, by the definition of retirement security adopted in this Article, replacement of 100% of final preretirement wages, adjusted for inflation, for all earners

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<sup>6</sup> See SENATE SPECIAL COMM. ON AGING, 96TH CONG., 2D SESS., EMERGING OPTIONS FOR WORK AND RETIREMENT POLICY 3-4 (Comm. Print 1980) [hereinafter EMERGING OPTIONS] (noting inadequacy of retirement income, suggesting that lost wages are a basic cause of that inadequacy, and concluding that "there is no guarantee that current programs left unchanged will ever yield a reasonable earnings-replacement rate in retirement"); COMING OF AGE, *supra* note 3, at 11 ("Today, retirement is thought of as the transition from full-time employment to full-time leisure.").

<sup>7</sup> See EMERGING OPTIONS, *supra* note 6, at 3-4 (noting problem of poverty among the elderly).

<sup>8</sup> See COMING OF AGE, *supra* note 3, at 49 ("[I]ndividuals should be able to maintain their preretirement standard of living during retirement years. Retirees should not have to experience a sudden drop in their standard of living.").

would satisfy national retirement security policy.<sup>9</sup>

This formulation of retirement security policy, that is, to provide a postretirement threshold income to all retirees and to maintain preretirement lifestyles, at least of moderate income workers, serves to clarify the proper spheres of public subsidies and private savings. Factors such as retirees' incapacity to respond to income losses by working harder, the special health and mortality uncertainties of retirement, the general inabilities of persons to assess adequately such risks during their young or middle years and, perhaps, a special or increased risk aversion of elderly persons, suggest that, although low- and moderate-income employees deserve the greatest public policy attention, some public role in encouraging retirement savings is warranted for all workers.<sup>10</sup> The risks of advanced age may serve to eliminate confidence about the continuing adequacy of even a substantial income level. Nonetheless, it seems clear that the public role should decline in importance as an individual's wealth increases and that, at some point, reliance on individual and familial savings should dominate. Presumably, wealthier retirees will own investment assets that will produce adequate investment income for consumption during retirement.

By the definition adopted in this Article, retirement security public policy goals are limited generally to replacing income lost through retirement, but even a 100% wage replacement program would not satisfy other national concerns. I ignore, for example, the general problems of poverty as well as the important need to provide health insurance, a particular need of the elderly.<sup>11</sup>

### B. *The Tripartite System of Programs*

Delineating the retirement security goal as a wage-replacement

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<sup>9</sup> This Article therefore defines retirement security policy fairly narrowly, as the replacement of lost wages due to retirement. Once 100% of these wages are replaced, retirement security, under this definition, is achieved. Issues that arise when the replacement of all of one's preretirement wages results in postretirement income that is below what is thought to be an adequate level of income are considered to be matters of poverty policy generally. While these concerns cannot be ignored, they are treated here as distinct from questions of retirement security.

<sup>10</sup> See Halperin, *Tax Policy and Retirement Income: A Rational Model for the 21st Century*, in SEARCH FOR A NATIONAL RETIREMENT SECURITY POLICY 159, 161 (J. VanDerhei ed. 1987); Thompson, *The Social Security Reform Debate*, 21 J. ECON. LITERATURE 1425, 1440-41 (1983).

<sup>11</sup> See *supra* note 9. Although antipoverty and health insurance programs might well be influenced by the inability of retirees to return to the labor force and are sometimes regarded both here and in other countries as an integral part of retirement security policy, this Article treats the antipoverty and health insurance issues as separate national problems and therefore does not discuss them.

goal helps to clarify the suitable functions of the various elements of our tripartite retirement security system. Social Security—a completely public program—might serve fully to meet the basic income adequacy goal for poorer workers, contribute substantially toward ensuring an adequate threshold retirement income for moderate income workers, and assist somewhat in postretirement lifestyle maintenance for all workers.<sup>12</sup> This vision of a public Social Security function would require at least all individuals who have enough earnings to satisfy current basic needs to substitute future for current consumption, for example by taxing current wages in exchange for subsequent wage-replacement retirement benefits. In addition, such a view regards as appropriate the redistributive aspects of Social Security and dismisses the contention that a public social security program should resemble an actuarially sound retirement insurance plan for all workers, even those at the highest income levels.<sup>13</sup> The dominant public role of retirement income security policy should be to ensure post-retirement income adequacy for low- and moderate-income workers.

At the other end of the income scale, private individual savings are most likely to ensure retirement income security for those workers who have earned sufficiently high lifetime wages (or who otherwise have sufficient investment assets) to enable them to use current savings to protect themselves from a substantial decline in living standard upon retirement.<sup>14</sup> The public role in this context should obviously permit, and perhaps facilitate, private savings for retirement, but the individual savings component of retirement security for higher income workers should be a primarily private matter. Once basic income adequacy during retirement is assured, the government might well remain generally neutral about individual decisions by high-income workers regarding

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<sup>12</sup> The President's Commission on Pension Policy has noted:

The [Social Security] program combines the goals of individual equity and social adequacy. On the one hand, there is a relationship between the earnings on which an individual pays social security taxes and what he or she receives in cash benefits. On the other hand, the program is partly redistributive, targeting benefits to those most in need.

COMING OF AGE, *supra* note 3, at 49.

<sup>13</sup> See Simon, *Rights and Redistribution in the Welfare System*, 38 STAN. L. REV. 1441, 1455-59 (1986) (examining the attenuation of the insurance analogy in the development of the social security program).

<sup>14</sup> See COMING OF AGE, *supra* note 3, at 45 ("[D]ue to income levels and the tax structure, higher income individuals are more likely to utilize a voluntary tax deferral program than are lower income people."); cf. Boskin, Kotlikoff, Puffert, & Shoven, *supra* note 2, at 26-27 (demonstrating that high-income earners receive a lower internal rate of return on social security taxes paid than that received by low-income earners within the same generation). For a detailed discussion of individual savings for retirement, see *infra* notes 169-209 and accompanying text.

the tradeoff between their own current and future consumption, except to the extent that this tradeoff may affect the tendency of employers to create and maintain pension plans that will benefit low- and moderate-income workers as well.

The appropriate role of the social security and individual savings elements of the tripartite retirement security program thus fits easily within this Article's articulation of retirement security goals. Private pensions present more of a problem. While it is clear that these employer-provided pensions often contribute to basic income adequacy, especially for low- and moderate-income workers, it is not nearly so clear to what extent employer-provided plans should serve to facilitate postretirement lifestyle maintenance for all workers.<sup>15</sup> Specification of the appropriate role for employer-sponsored pension plans depends both on the overall ambitions of the national retirement security program and on the adequacy of social security. The voluntariness of such plans links them to individual savings, while their collective nature with respect to benefits and risks as well as with respect to employer and regulatory limitations on employee choices, suggests a public nature. Dominant reliance on income tax incentives as the public stimulus for employer plans necessarily confounds retirement security and income tax policies.

As this Article will develop further, the necessary function of employer-provided pension plans in bridging the public antipoverty/basic income adequacy function of Social Security and the private lifestyle maintenance function of individual savings creates substantial tensions in the formulation of public policy regarding such plans. Typically, the tensions are manifested by debates over the appropriate conditions that must be met by private pensions in order to qualify for income tax benefits<sup>16</sup> and over the propriety and effects of extending similar benefits to private individual retirement savings plans.<sup>17</sup> Viewing employer pensions as an integral part of a coherent national retirement security policy, however, also requires coordinating the significant features of employer plans with the distribution of the benefits and burdens of both Social Security and the public aspects of individual savings. Ultimately, this raises questions about the ability of voluntary employer

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<sup>15</sup> See A. MUNNELL, *supra* note 4, at 25-28 (questioning the role of private pensions in bridging the gap between pre- and postretirement income).

<sup>16</sup> See, e.g., J. ROSENBLOOM & G. HALLMAN, *EMPLOYEE BENEFIT PLANNING* 268-71 (1981) (discussing eligibility of retirement plans for preferential tax treatment under ERISA); N. Altman Lupu, *supra* note 2, at 60-70 (criticizing as inadequate, from a retirement security policy standpoint, the 1986 Tax Reform Act's conditions on eligibility of pensions for favored tax treatment).

<sup>17</sup> See *infra* notes 171-98 and accompanying text.



plans to fulfill their critical function in national retirement security policy.

### C. *The Critical Role of Federal Tax Policy*

Because they implement this nation's retirement security policy, federal tax provisions and policies serve as a common mechanism influencing all three means of financing retirement security. The dominant role of the payroll tax as the implementation mechanism for funding Social Security is obvious and has been the subject of considerable expert and public attention.<sup>18</sup> The public, however, has paid far less attention to the dramatic effect that federal tax rules have on employer-provided pensions and on individual savings. The income "tax expenditure" provisions for qualified employer-provided pension plans<sup>19</sup> and for individual savings, principally through "individual retirement accounts"<sup>20</sup> are the most important of these rules. The income tax advantages for savings in other forms, such as home ownership and life insurance policies,<sup>21</sup> also have an effect. Relationships among all of these

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<sup>18</sup> See, e.g., A. Munnell, *supra* note 2, at 2; J. Tobin, *supra* note 2, at 3; see also *Tax Burdens of Low-Income Wage Earners: Hearing Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means*, 99th Cong., 1st Sess. 23-77 (1985) [hereinafter *Tax Burdens*] (testimony on the inequities of the tax system, including the payroll tax); *Taxes, Social Security and the Deficit: Hearing Before the House Select Comm. on Aging*, 99th Cong., 1st Sess. 53-82 (1985) [hereinafter *Taxes Hearing*] (testimony on the inequitable burden the payroll Social Security tax places on low-income wage earners). See generally Thompson, *supra* note 10, at 1426-30 (basic description of framework of social security benefit programs).

<sup>19</sup> See I.R.C. § 401(a) (1982 & Supp. III 1985 & West Supp. 1987: Tax Reform Act of 1986 Special Pamphlet [hereinafter West Supp. 1987]), § 402(a)(1) (1982); see also N. Altman Lupu, *supra* note 2, at 2 n.4 ("In 1986, approximately \$79 billion was excluded from annual income tax liability as a consequence of pension contributions to and earnings under employer-sponsored pension arrangements."). See generally Halperin, *supra* note 10 (discussing possible restructuring of tax incentives for employer-sponsored pension plans). For a compilation of recent statistics on the impact of the tax expenditure provisions, see STAFF OF JOINT COMM. ON TAXATION, 100TH CONG., 2D SESS., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1988-1992 (Joint Comm. Print 1987) [hereinafter JT. COMM. ESTIMATES].

<sup>20</sup> See I.R.C. § 408 (1982 & Supp. III 1985 & West Supp. 1987); see also EMPLOYEE BENEFIT RESEARCH INSTITUTE, ISSUE BRIEF NO. 52, RETIREMENT INCOME AND INDIVIDUAL RETIREMENT ACCOUNTS 1 (1986) [hereinafter EBRI, IRAs] ("The Department of the Treasury estimates the federal revenue loss associated with the IRA tax deduction at \$12.7 billion in 1985.").

<sup>21</sup> See SENATE COMM. ON THE BUDGET, 99TH CONG., 2D SESS., TAX EXPENDITURES: RELATIONSHIPS TO SPENDING PROGRAMS AND BACKGROUND MATERIAL ON INDIVIDUAL PROVISIONS 121, 155-63 (Comm. Print 1986) [hereinafter TAX EXPENDITURES] (providing estimated revenue losses from tax-favored treatment for home owners and life insurance policies); see also JT. COMM. ESTIMATES, *supra* note 19, at 10-17 table 1. See generally Merrill, *Home Equity and the Elderly*, in RETIREMENT AND ECONOMIC BEHAVIOR 197 (H. Aaron & G. Burtless eds. 1984) (examining the role of home equity as an alternative source of retirement income).

tax provisions have been largely ignored.

A unified approach to retirement security policy thus requires rejection of traditional analyses that test the efficiency or equity of these provisions by reference to the internal norms of either the income tax or the social security system.<sup>22</sup> In other words, to look to the impact upon the income tax system of only the retirement security tax provisions is inadequate, as is regarding the social security retirement system as if it were a closed and complete social insurance scheme. In some cases, the law itself has made explicit certain relationships between the income tax and social security provisions. For example, the income tax nondiscrimination requirements for employer-provided pension plans have long contained so-called "integration" rules that, in effect, have treated social security benefits as if they were provided by the employer and allowed pension plans to qualify for favorable income tax treatment even if they were restricted so as to be only supplemental to social security benefits.<sup>23</sup> Recent legislation has included important new provisions that explicitly link the social security tax and the income tax. The most important of these are the 1975 enactment and 1986 expansion of an "earned income tax credit,"<sup>24</sup> which provides income tax refunds to low-income families as a partial offset to their social security tax burdens, and the inclusion under the 1983 Social Security Tax Amendments of a portion of social security benefits in taxable income.<sup>25</sup>

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<sup>22</sup> See generally A. MUNNELL, *supra* note 4 (private pensions); Simon, *supra* note 13, at 1448-77 (social security).

<sup>23</sup> See I.R.C. § 401(a)(5) (West Supp. 1987). For the argument that pre-1986 integration practices allowed pension plans to discriminate in favor of highly paid employees, see Wolk, *Discrimination Rules for Qualified Retirement Plans: Good Intentions Confront Economic Reality*, 70 VA. L. REV. 419, 445-49 (1984). The impact of integration on the question of who receives pension plan benefits varies with the extent to which integration is practiced across different types of plans and the type of integration method and benefits/earnings levels used. See Halperin, *supra* note 10, at 168-71; N. Altman Lupu, *supra* note 2, at 61. For a more detailed discussion of this issue, see *infra* notes 143-45 and accompanying text.

<sup>24</sup> The 1975 Earned Income Tax Credit ("EITC") legislation applied to families earning a maximum of \$11,000 with at least one child. The maximum tax credit allowed was \$550. See Tax Reduction Act of 1975, Pub. L. No. 94-12, § 204(a), 89 Stat. 26, 30 (current version at I.R.C. § 32 (Supp. III 1985 & West Supp. 1987)). Under the Tax Reform Act of 1986, the maximum earnings allowed are raised to \$17,000, see I.R.C. § 32(b) (West Supp. 1987), and the maximum credit is raised to \$800, see I.R.C. § 32(a), (b) (West Supp. 1987). Additionally, the phase-out income range is adjusted for inflation. See I.R.C. § 32(i) (West Supp. 1987). For a discussion of the EITC and its effect on low- and moderate-income earners, see Steuerle & Wilson, *The Taxation of Poor and Lower-Income Workers*, 34 TAX NOTES 695, 702-05 (1987).

<sup>25</sup> See Social Security Amendments of 1983, Pub. L. No. 98-21, § 121(a), 97 Stat. 65, 80-81 (1983) (codified as amended at I.R.C. § 86 (Supp. III 1985 & West Supp. 1987)). See generally *Taxes Hearing*, *supra* note 18 (testimony criticizing the increase in taxes on social security benefits). These provisions operate in a manner that, in

The use of the tax system to implement retirement security policy not only raises questions about the efficacy and fairness of tax law as the dominant method of implementation but also requires an evaluation of how using the tax code to facilitate the provision of retirement income security interacts with overall national tax policies. Both the social security tax provisions and the income tax provisions recently have been subject to significant revisions. The 1983 Social Security Amendments apparently have put that program on a sound financial footing for many years to come,<sup>26</sup> and the massive 1986 Tax Reform Act contains substantial revisions to the income tax rules governing both private employer-provided pensions and individual retirement savings,<sup>27</sup> changes that are intended to make these provisions more responsive to national retirement security concerns. These recent re-examinations of social security financing and income tax policies toward retirement savings make this an auspicious time—one almost uniquely free from a crisis atmosphere—for reviewing federal tax policies designed to facilitate retirement income security for the populace.

#### D. *The Relationship of Tax Equity and Retirement Security Concerns*

Tax equity requires that tax burdens be correlated with people's ability to pay. Persons with equal ability to pay taxes should pay equal taxes, and persons with greater ability should pay greater taxes.<sup>28</sup> The ability-to-pay criterion enjoys broad acceptance as a fundamental tenet of tax justice, although the details of its implementation are controversial. For example, user charges are typically regarded as properly exempted from the ability-to-pay requirement, and disputes often arise over issues such as whether the ability-to-pay criterion should be ap-

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present value terms, under reasonable assumptions, parallels the income tax treatment of qualified employer-provided pension plans.

<sup>26</sup> See BOARD OF TRUSTEES OF THE FEDERAL OLD-AGE SURVIVORS INSURANCE AND DISABILITY INSURANCE TRUST FUNDS, 1985 ANNUAL REPORT, H.R. DOC. NO. 99, 99th Cong., 1st Sess. 62-63, 73-74 (1985) [hereinafter 1985 ANNUAL REPORT]; A. Munnell, *supra* note 2, at 8-12. See generally Ballantyne, *Actuarial Status of the OASI and DI Trust Funds*, SOC. SEC. BULL., June 1985, at 27 (summarizing the current financial and actuarial status of old-age, survivors, and disability insurance ("OASDI") programs as shown in 1985 ANNUAL REPORT.)

<sup>27</sup> See, e.g., Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 1101 (limitations on IRA deductions), 1111-1120 (enhanced nondiscrimination rules), 1121-1124 (taxation of accumulations in qualified pension plans), 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) \_\_\_\_ (to be codified in scattered sections of I.R.C.). For a good general discussion of these provisions, see N. Altman Lupu, *supra* note 2, at 30-82.

<sup>28</sup> See M. GRAETZ, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 15 (successor ed. 1985).

plied on an individual or family basis,<sup>29</sup> whether it requires progressivity or only proportionality in the distribution of tax burdens,<sup>30</sup> and whether it should be applied independently to each significant tax imposed or to the tax system as a whole.<sup>31</sup> One need not reach the controversial boundaries, however, to conclude that the tax provisions implementing our national retirement security goals not only fail to satisfy an ability-to-pay criterion but also present a serious threat to this basic principle of tax justice.

A demonstration of this important point requires scrutiny of three related issues. We must first ask whether the tax provisions implementing national retirement security policy, viewed as a coherent whole, satisfy the fundamental principle of tax equity. If not, we must inquire whether there are compensating features of the tax system that redress the failures internal to the retirement security provisions, thereby assuring that the ability-to-pay criterion is satisfied as a matter of general tax policy. If no comfort is found either in the retirement security tax provisions or in overall tax policy, we must then ascertain whether the distribution of federal retirement security benefits sufficiently offsets failures revealed on the tax side.

The enormous growth of the payroll tax to finance social welfare programs and, especially, to finance the retirement component of social security, is surely the most significant development in the federal tax structure in the past thirty years. In 1954, these taxes accounted for 10% of budget receipts, but by 1984, payroll taxes had risen to a total of \$241 billion dollars, or 36% of 1984 federal revenues.<sup>32</sup> Total payroll tax rates have risen from 8.8% in 1967 to the current 14.3%.<sup>33</sup>

Simultaneously with this great tax increase on labor income, we have experienced an almost equally striking decline in taxes on capital, most dramatically in the portion of federal revenues generated by the

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<sup>29</sup> See *id.* at 456-75.

<sup>30</sup> See *id.* at 21-27.

<sup>31</sup> See *id.* at 18-21.

<sup>32</sup> See *Federal Tax Treatment of Low Income Persons: Hearing Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 98th Cong., 2d Sess. 11 (1984) [hereinafter *Tax Treatment*] (statement of Charles McLure, Dep. Ass't Sec. for Tax Analysis, Dept. of Treasury) (estimated 1985 statistics); see also CONGRESSIONAL BUDGET OFFICE, A REPORT TO THE SENATE AND HOUSE COMMS. ON THE BUDGET, THE ECONOMIC AND BUDGET OUTLOOK: AN UPDATE 55 (1986) (projection that social insurance revenue will be approximately 36% of GNP in 1984-1989).

<sup>33</sup> See I.R.C. § 3101(a) (1982 & Supp. III 1985), (b) (1982); J. Tobin, *supra* note 2, at 25. "The growing importance of the payroll tax in the federal tax structure has been a major factor in reducing the progressivity of the system, especially over the lower end of the income scale and for the working-age population." Musgrave, *supra* note 2, at 110. See generally J. PECHMAN, WHO PAID THE TAXES 1966-85? (1985) (discussing distribution of tax burdens by income class).

corporate income tax. These taxes accounted for 28.4% of federal revenues in 1953. By 1983, they accounted for only 6.6%.<sup>34</sup> The individual income tax, by contrast, has been a relatively steady source of federal revenues, producing 45.2% of the total in 1953 and 47.2% in 1983.<sup>35</sup>

This shift in federal tax sources over time—payroll taxes increasing greatly while corporate income taxes declined significantly—has affected significantly the allocation of the federal tax burden between taxes on capital and taxes on labor. In 1986, the tax rate on labor income was estimated to be nearly double that on capital income.<sup>36</sup> Other estimates suggest a total average tax rate on income from capital of about 13.7%,<sup>37</sup> a rate not substantially greater than the 12.4% rate in combined income and FICA taxes paid in 1986 by individuals who earn one-half of median income.<sup>38</sup>

If the basic principle of tax justice requiring taxes to be distributed

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<sup>34</sup> See M. GRAETZ, *supra* note 28, at 5. Calculations of the declining proportion of federal revenue contributed by the corporate income tax vary, but all point to a substantial decline. "Previous to 1950, corporations were paying 40 percent of the tax in this Nation." *Tax Burdens, supra* note 18, at 7 (statement of Speaker O'Neill). "In 1954, corporations were paying 30.3 percent, and now they are paying 8.5 percent . . ." *Id.* See also Auerbach, *The Corporation Income Tax*, in *THE PROMISE OF TAX REFORM* 59, 59-61 (J. Pechman ed. 1985).

The 1982 legislation increased the percentage of federal revenues generated by the corporate income tax to about 10% in 1984. Critics argue, however, that the combined effect of the 1981 and 1982 tax acts regarding the amount of corporate taxes paid will result in "a reduction in the corporate tax revenues by about 22 percent to 25 percent between 1984 and 1988." E. STEUERLE, *TAXES, LOANS, AND INFLATION* 33 (1985). The Tax Reform Act of 1986 is intended to increase somewhat the contribution to federal revenues of the corporate income tax. See 2 TAX REFORM ACT OF 1986, H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. 264 (1986) [hereinafter CONF. REP.].

<sup>35</sup> See M. GRAETZ, *supra* note 28, at 5. The share of federal revenues from income tax has been steady, ranging between 42% and 48% of revenues.

<sup>36</sup> These rates were estimated at 19% and 11% respectively. See J. PECHMAN, *supra* note 33, at 73 table 5-5 (assuming the least progressive set of incidence assumptions). Viewed differently, capital income is not taxed as completely as labor income. "[A]pproximately 40 percent of all capital will earn tax-exempt income." Ballentine, *Broadening Our Approach to Income Tax Reform*, 5 AM. J. TAX POL'Y 1, 2 (1986).

<sup>37</sup> See Ballentine, *supra* note 36, at 3 (relying on 1982 figures based on an effective tax rate of about 23% on income from business capital and essentially zero on income from nonbusiness capital). Dividing tax revenues on net capital income by the amount of net capital income in the economy yields an effective income tax rate as low as 7.5% on all capital income. See E. STEUERLE, *supra* note 34, at 13. This disparity, coupled with the income tax treatment of borrowing, leads to tax arbitrage opportunities. See *infra* notes 204-09 and accompanying text.

<sup>38</sup> This figure does not take into account the employer's share of FICA taxes paid on the employees' behalf, even though these taxes are almost certainly also borne by the employees. Additionally, combined federal income and FICA taxes total 10.8% of income for those families at the poverty level in 1983. See *Tax Treatment, supra* note 32, at 30 (statement of Charles McLure). Some critics argue that "the combined marginal income and payroll tax rate for a family of four earning \$12,000 a year is actually higher than tax rates . . . on profits from capital gains. . . ." *Id.* at 56 (statement of Robert Greenstein, Dir., Center on Budget and Policy Priorities).

in accordance with ability to pay is to be satisfied, a significant portion of the tax burden must be borne either by wealth (or wealth transfers) or income from capital. Taxes on labor income alone—even if, unlike FICA taxes, they were progressively structured—do not produce taxation based upon ability to pay, for those with the greatest ability to pay often have channelled their monies into capital.<sup>39</sup> Thus, although taxes on wages may be appropriate as a primary mechanism for ensuring low- and moderate-income workers an adequate postretirement income, the massive increase during recent decades in the relative tax burden on labor is cause for concern.<sup>40</sup> Regardless of whether the overall allocation of federal taxes between labor and capital is considered to meet minimal standards of tax fairness, this brief overview suggests that if the retirement security provisions themselves do not satisfy the basic ability-to-pay criterion, there is little reason to believe that difficulties internal to these provisions will be compensated for by the federal tax system as a whole. We must therefore examine the particular tax provisions affecting the three components of the unified retirement security policy in an effort to judge whether these provisions, viewed as a coherent whole, satisfy the fundamental ability to pay principle of tax justice. The payroll tax is the appropriate place to begin.

## II. INEQUITIES WITHIN THE PAYROLL TAX

While the social security tax rate is a proportional one,<sup>41</sup> the social security tax burden is regressive.<sup>42</sup> The fundamental problems in the imposition of payroll taxes to finance Social Security occur at the bot-

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<sup>39</sup> See Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 YALE L.J. 259, 270 (1983).

<sup>40</sup> "In 1966 the tax burden on capital income was substantially higher than the burden on labor income. This pattern was reversed by 1985 as a result of the reduced roles of the corporation income tax and the property tax and the greater role of the payroll tax." J. PECHMAN, *supra* note 33, at 8-9. The Tax Reform Act of 1986 may well produce some increase in the share of taxes borne by capital income, principally through increases in corporate income tax and, in any event, reflects a significant effort by Congress to restrict widespread individual and corporate income tax opportunities for avoiding taxes on capital income. See generally 2 CONF. REP., *supra* note 34, at 158-249, 264-84 (detailing changes in corporate taxation), 137-50 (detailing limitations on losses and credits from passive activities).

It seems unlikely that the revision of the overall shares of taxes borne by labor and capital through the 1986 Tax Reform Act will have a substantial impact on the ever-increasing tax burden on labor income. See *Tax Burdens*, *supra* note 18, at 52 (statement of Prof. Harold Hochman). This prophecy is supported by the existence of prior amendments to the Social Security Act that will continue to increase payroll taxes in the future.

<sup>41</sup> See I.R.C. § 3101(a) (Supp. III 1985).

<sup>42</sup> See J. PECHMAN, *supra* note 33, at 55-56 & table 4-9; Steuerle & Wilson, *supra* note 24, at 700.

tom and top ends of the tax schedule. The payroll tax provides no exemption level or floor on wages below which the tax is not imposed, but it does contain a maximum level or ceiling on wages subject to tax.<sup>43</sup>

### A. *The Payroll Tax Burden on the Working Poor*

Historically, the most significant inequity in the social security tax has been its imposition of a substantial tax burden on the working poor.<sup>44</sup> This burden has become of greater import as increasing numbers of poor individuals and families are receiving a larger share of their income from earnings—the percentage of total income from earnings of families at the poverty level increased from 28% in 1974 to 40% in 1981.<sup>45</sup> Unlike most tax systems, such as the income tax, the first dollar of wages is subject to social security tax. Thus, in 1981, 42% of all households below the poverty level paid social security payroll taxes.<sup>46</sup> As a result, for a family of four at the poverty level in 1984, payroll taxes equalled \$711, nearly double the income tax burden of \$365.<sup>47</sup> The 1986 removal of six million poverty-level families from the income tax rolls will not stem these trends; it leaves the payroll tax as the only substantial federal tax imposed on the working poor.<sup>48</sup>

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<sup>43</sup> See *infra* note 60 and accompanying text.

<sup>44</sup> See *Tax Treatment*, *supra* note 32, at 11 (statement of Charles McLure); see also Steuerle & Wilson, *supra* note 24, at 707 (“The most significant increase in direct taxes for poor and lower-income workers . . . has been not the income tax, but the Social Security tax. . . . Currently, many lower-income workers are making substantial transfers to middle-income retirees whose contributions into the system were at much lower rates of taxation.”). See generally *Work and Poverty: The Special Problems of the Working Poor: Hearing Before the Subcomm. on Employment and Housing of the House Comm. on Govt. Operations*, 99th Cong., 1st Sess. 21-22 table 5 (1985) (statement of Professors Sheldon Danziger and Peter Gottschalk) [hereinafter *Working Poor*] (noting the steady increase in social security taxes from 1965 to 1984).

<sup>45</sup> See *Tax Treatment*, *supra* note 32, at 35 (statement of John F. Coder, Income Statistics Branch Chief, Bureau of Census).

<sup>46</sup> Payroll taxes are a significant tax burden for the working poor. “Although persons with incomes near the poverty line generally pay little in Federal income taxes, 6.7 percent of their earnings go for payroll taxes.” *Census and Designation of Poverty and Income: Joint Hearing Before the Subcomm. on Census and Population of the House Comm. on Post Office and Civil Service and the Subcomm. on Oversight of the House Comm. on Ways and Means*, 98th Cong., 2d Sess. 40 (1984) [hereinafter *Census*] (statement of Eric Hanushek, Dep. Dir., Congressional Budget Office).

<sup>47</sup> See *Tax Treatment*, *supra* note 32, at 11 (statement of Charles McLure). If payroll and income taxes are considered, the 1980 national poverty rate increases from 13.3% to 14.1%. See *Census*, *supra* note 46, at 23 (statement of Louis Kincannon, Dep. Dir., Bureau of Census). In 1982, 3.2 million persons in families who had gross incomes above the poverty line were pushed below the poverty line due to their income and payroll tax obligations. See *Tax Burdens*, *supra* note 18, at 69 (statement of Robert Greenstein).

<sup>48</sup> See 2 CONF. REP., *supra* note 34, at 2-9 (summarizing changes in tax rates and

Beginning in 1975, Congress recognized these fundamental inequities and enacted an Earned Income Tax Credit ("EITC") into the income tax to reduce the burden on poor families with dependent children.<sup>49</sup> In addition, the 1986 legislation increased the EITC maximum earnings level and introduced indexing of the credit for inflation.<sup>50</sup> To the extent that the earned income credit exceeds the income tax liability of poor families, it, in effect, serves as a reduction in the social security tax burden of those families.<sup>51</sup> Even after its latest expansion, however, this indirect relief from the social security tax burden of the working poor remains an inadequate substitute for a minimum income level for exemption from the social security tax burden. For example, the earned income tax credit is available to only a limited portion of the working poor, namely, families with dependent children.<sup>52</sup> Moreover, if experience with the prior mechanism to relieve income taxes as an offset to social security taxes—the retirement income credit<sup>53</sup>—is any guide, the earned income tax credit seems likely not to be claimed by a substantial

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rate structure of the Tax Reform Act of 1986); *Working Poor*, *supra* note 44, at 21-22 table 5 (statement of Professors Sheldon Danziger and Peter Gottschalk).

<sup>49</sup> See Tax Reduction Act of 1975, Pub. L. No. 94-12, § 204(a), 89 Stat. 26, 30 (current version at I.R.C. § 32 (Supp. III 1985 & West Supp. 1987)); see also Steuerle & Wilson, *supra* note 24, at 702 (discussing effect of 1986 Tax Reform Act on the EITC and noting likely consequences of the amendment).

<sup>50</sup> See Tax Reform Act of 1986, Pub. L. No. 99-514, § 111(a), (b) (increasing maximum earning level), (c) (indexing for inflation), 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) — (to be codified at I.R.C. § 32(a), (b) and § 32(c), respectively).

<sup>51</sup> "The EITC largely eliminates the burden of Social Security taxes for many low-income workers. Since the credit is refundable, it offsets more than income tax liability for some households." Steuerle & Wilson, *supra* note 24, at 704.

<sup>52</sup> See I.R.C. § 32(c) (Supp. III 1985 & West Supp. 1987). The EITC has been criticized in other respects as well. Steuerle and Wilson argue:

[T]he EITC has several problems. Eligibility for the EITC does not depend on a recipient's assets and other criteria common to welfare programs. Eligibility also is unaffected by the receipt of nontaxable income. Thus, some recipients of the credit are millionaires with large amounts of tax shelter income. The credit also may go to those with significant amounts of income excluded from income taxation, such as workers' compensation. Thus, although the tax system has advantages as a means for promoting welfare policy goals—it is simple and can easily identify participants based upon tax data that is already filed—one major disadvantage is that not all relevant information is reported on tax forms. Moreover, the definition of a household for tax purposes may differ from that which is most appropriate for a welfare program. The latter, for instance, may count several tax units as a single household for welfare purposes.

Steuerle & Wilson, *supra* note 24, at 702-03.

<sup>53</sup> See I.R.C. § 22 (Supp. III 1985 & West Supp. 1987). For a discussion of the retirement income credit, see E. GRISWOLD & M. GRAETZ, *FEDERAL INCOME TAXATION PRINCIPLES AND POLICIES* 463-65 (successor ed. 1976).



number of the families entitled to it.<sup>54</sup> Finally, there is a temptation to double count the tax benefits of the earned income tax credit; it is sometimes credited with helping to remove poverty level families from the *income* tax rolls at the same time as it is described as relieving *payroll* tax burdens of the working poor. Thus, the 1986 legislation is no remedy to the unfairness of subjecting poor working families to a significant social security tax burden.

Economists generally agree that both the employers' and the employees' shares of social security taxes are borne by employees in the form of reduced wages.<sup>55</sup> The current combined payroll tax rate of 11.4%<sup>56</sup> is a substantial, unjustifiable burden on low income workers. In recent years, the combined marginal income and payroll tax rate on a family of four earning \$12,000 a year has been greater than the tax rate paid by wealthy investors on profits from capital gains.<sup>57</sup> While the 1986 income tax legislation may well reverse this particular relationship, it fails to address directly the basic problem of the sizeable tax burden of payroll taxes on the working poor.

The burden of social security taxes on the working poor is exacerbated by the income tax treatment of the social security tax. For those low- and moderate-income workers who are subject to the income tax, the inclusion of the social security tax in current wages<sup>58</sup> and the corresponding subjection of that tax to current income taxation, while

<sup>54</sup> Employers who are unaware of or who do not want to be bothered with computing the credit may, intentionally or unintentionally, fail to deduct the income from the employee's withholding. The employee must then claim the credit on her tax return or wait for the IRS to discover the omission. Moreover, workers who do not need to file an income tax return may "fall through the cracks" by not filing to claim a refund. See *Tax Treatment*, *supra* note 32, at 68 (statement of Dr. Joseph J. Minarik, Urban Institute); see also *Tax Burdens*, *supra* note 18, at 43 (statement of Prof. Alvin Schorr) (persons who do not owe taxes are entitled to refunds if eligible for the EITC); cf. *Tax Treatment*, *supra* note 32, at 30 (statement of Charles McLure) (estimating that the number of nonfilers eligible for the EITC, although uncertain, is probably fewer than one million and noting that the I.R.S. encourages nonfilers eligible for the EITC to file).

<sup>55</sup> See Steuerle & Wilson, *supra* note 24, at 700-01 ("It is generally assumed that both the employee and employer portions of the Social Security tax are borne by the employee."); Thompson, *supra* note 10, at 1453 (noting that both shares are "actually born [sic] by the employee in the form of lower real wages"); see also J. PECHMAN, *supra* note 33, at 23-37; Break, *The Economic Effects of the OASDI Program*, in SOCIAL SECURITY FINANCING, *supra* note 2, at 45, 49 (citing studies). But see Browning, *Tax Incidence, Indirect Taxes, and Transfers*, 38 NAT'L TAX J. 525, 532 (1985) (arguing that the "social security payroll tax cannot fall exclusively on labor income").

<sup>56</sup> See I.R.C. §§ 3101(a) (rate on employees), 3111(a) (rate on employers) (1982 & Supp. III 1985). It should be noted that, with Medicare, the total tax rate rises to 14.3%. See *supra* text accompanying notes 32-33.

<sup>57</sup> See *Tax Treatment*, *supra* note 32, at 56 (statement of Robert Greenstein); accord *Tax Burdens*, *supra* note 18, at 68.

<sup>58</sup> See I.R.C. § 3121(a) (1982 & Supp. III 1985 & West Supp. 1987).

equivalent in present value terms (so long as tax rates remain constant) to the treatment of private pensions, requires further deferral of current consumption.<sup>59</sup>

The substantial payroll tax burden on the working poor violates principles of tax justice and cannot be defended either by reference to ultimate benefits that the working poor may expect to receive from social security during their retirement or by the public nature of the social security program. The goal of providing a basic income level to poor workers after their retirement is simply no justification for mandatory social security provisions that require poor workers to shift consumption from the present to the future. At a minimum, poor workers should be exempted from paying social security taxes after they have participated in the payroll tax system for a sufficient number of quarters to qualify for payment of minimum benefits.

### B. *The Payroll Tax Wage Ceiling and the Exclusion of Fringe Benefits*

The regressivity of the social security tax also occurs because of the declining effective rate of tax that results from the ceiling on wages subject to the payroll tax. Under current law, all wages over \$43,800 are exempt from payroll taxes.<sup>60</sup> In addition, significant fringe benefits are exempted, and these may accrue disproportionately to higher wage earners. Each of these problems demands solution.

Nontaxable fringe benefits as a percentage of employee compensation subject to the payroll tax were estimated to amount to about 8% in 1960 and 16% in 1984. The Social Security Trustees' Report estimates that by the year 2060 fringe benefits will comprise more than one-third of total compensation.<sup>61</sup> While this estimation is merely an extrapolation from the past and thus may not be reliable, it does not seem unreasonable. While nontaxable fringe benefits have amounted to approxi-

<sup>59</sup> See M. GRAETZ, *supra* note 28, at 342-46 (discussing timing issues); Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575, 1597-1623 (1979) (extensively discussing timing issues, particularly with respect to investments, consumer durables, and housing). See generally Halperin, *Interest in Disguise: Taxing the "Time Value of Money,"* 95 YALE L.J. 506 (1986) (discussing taxation problems caused by timing of realization of investment income); Warren, *The Timing of Taxes*, 39 NAT'L TAX J. 499 (discussing conditions under which deferral or acceleration will not affect present value).

<sup>60</sup> See 42 U.S.C. § 430(b) (1982); 50 Fed. Reg. 45,558, 45,559 (1985).

<sup>61</sup> See *Distribution and Economics of Employer-Provided Fringe Benefits: Hearings Before the Subcomm. on Social Security and the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means*, 98th Cong., 2d Sess. 51 (1985) [hereinafter *Distribution*] (statement of C. Ballantyne, Chief Actuary, Social Security Administration).

mately 16% of compensation subject to the payroll tax, the percentage is substantially higher in relation to total compensation. For example, the Chamber of Commerce estimated that in 1981 fringe benefits amounted to 37% of total wages.<sup>62</sup> The percentage is lower in discussions of social security because of the interaction of the fringe benefit estimates and the wage ceiling on the payroll tax. Since fringe benefits, particularly pension benefits, tend to rise as a proportion of wages as wages rise, there is substantial interaction between the exclusion of fringe benefits and the existence of the wage ceiling. Obviously, the inclusion of fringe benefits in the payroll tax base would be of greater importance if the wage ceiling were repealed. Even under current law, however, the shift from cash compensation to fringe benefits narrows the social security wage base and requires a higher tax rate to produce identical revenues.<sup>63</sup>

A significant gain in tax equity would be accomplished by including currently excluded fringe benefits in the social security wage base. Some gain would occur even if fringe benefits, as a percentage of total compensation, were distributed relatively equally throughout income classes because those with high-income would bear a higher burden in funding the social security wage base. Greater gains would occur if, as is certainly true for pension benefits, high-income taxpayers had greater opportunity to obtain compensation in the form of excluded fringe benefits.<sup>64</sup>

Implementing such a proposal would not be difficult technically. The rules under section 401(k) of the Internal Revenue Code with respect to certain employee benefit plans<sup>65</sup> provide a guide for including fringe benefit items in the social security wage tax base, even if those

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<sup>62</sup> See M. GRAETZ, *supra* note 28, at 96 (citation omitted).

<sup>63</sup> An official of the Federal Reserve Bank of Boston has noted:

1984 payroll tax receipts would have been \$25 billion higher if employee benefits were included in the payroll tax base. Alternatively, the 1984 Social Security payroll tax rate . . . could have been lowered from 5.7 percent each for the employer and employee to 5.2 percent, without any reduction in 1984 revenues.

*Distribution*, *supra* note 61, at 418 (statement of A. Munnell, Senior Vice Pres. and Dir. of Research, Federal Reserve Bank of Boston). Exclusion of fringe benefits produces inequities because fringe benefits are concentrated among higher paid employees, yet all taxpayers must pay for the tax expenditure. See *id.* at 424; see also 42 U.S.C. § 409 (1982 & Supp. III 1985 & West Supp. 1987) (defining wages for purposes of federal old-age, survivors, and disability insurance benefits).

<sup>64</sup> This point turns, to some extent, on my conclusion that those who claim that the elimination of the wage ceiling would require a massive increase in maximum benefits misunderstand the role of the social security program in a comprehensive national retirement security system. See *infra* notes 70-72 and accompanying text.

<sup>65</sup> See I.R.C. § 401(k) (1982 & Supp. III 1985 & West Supp. 1987) (profit-sharing, stock bonus plans).

items are excluded from the income tax base. Under present law including fringe benefits in the income tax base would automatically include such benefits in the social security tax base.<sup>66</sup>

Equity also would be significantly improved by eliminating the wage ceiling on payroll taxes. Currently only about 6% of workers covered by social security earn more than the maximum taxable earnings base.<sup>67</sup> As the earnings of these individuals rise, the effective social security tax rate lessens as a percentage of total wages. Elimination of the wage ceiling would permit a revenue-neutral reduction of about 2% in the payroll tax rate,<sup>68</sup> or, alternatively, could finance significant tax relief for the working poor without affecting the overall financial stability of the social security system. Moreover, the elimination of the wage ceiling, if accompanied either by a rate reduction or an exemption for the working poor, would not increase the overall burden of the payroll tax on labor and, therefore, would not further shift the tax burden from

<sup>66</sup> See 42 U.S.C. § 409 (1982 & Supp. III 1985 & West Supp. 1987) (providing that exclusions from wages under I.R.C. § 3121 (1982 & Supp. III 1985 & West Supp. 1987) (relating to income tax withholding) are not applicable to determinations of wages subject to social security tax). The Social Security Amendments Act of 1983 subjected § 401(k) plan payments to social security taxes, see Pub. L. No. 98-21, § 121(a), 97 Stat. 65, 80 (1983) (codified at I.R.C. § 86 (1982 & Supp. III 1985 & West Supp. 1987)), while allowing tax-advantaged treatment for income tax purposes, see *id.* § 123, 97 Stat. at 87-89 (codified at I.R.C. § 3101 (1982 & Supp. III 1985)); § 124, 97 Stat. at 89-91 (codified at I.R.C. § 1401 (1982 & Supp. III 1985)); see also Steuerle & Wilson, *supra* note 24, at 707-08 (recommending, inter alia, expanding the social security tax base to include fringe benefits that are presently excluded from taxation).

<sup>67</sup>

Social Security Tax Rates, Maximum Taxable Payroll,  
Taxable Payroll as a Percent of Total Payroll,  
and the Percent of Workers with Earnings  
below the Taxable Maximum, in Selected Years 1960-1983

Year	Tax Rate (Percent)	Maximum Taxable Wages and Salaries	Reported Taxable Wages and Salaries as a Percent of Total Wages and Salaries	Percent of Workers with Earnings below Social Security Taxable Maximum
1960	3.0	\$ 4,800	79.9	72.6
1970	4.8	7,800	80.4	74.9
1980	6.1	25,900	90.0	91.5
1981	6.6	29,700	90.4	93.0
1982	6.7	32,400	90.7	93.5
1983	6.7	35,700	91.2	94.5

Source: *Tax Reform Proposals-XVII: Employee Benefits: Hearing Before the Senate Finance Comm.*, 99th Cong., 1st Sess. 196 table IV.2 (1985) (reprinting chapter 4 of a study done by Dr. Chollet of EBRI).

See Thompson, *supra* note 10, at 1426.

<sup>68</sup> See *Taxes Hearing*, *supra* note 18, at 3 (statement of Rep. Roybal).

capital to labor. The massive cuts in the top income tax rate—from 70% in 1981 to 28% in 1988<sup>69</sup>—and the attendant virtual elimination in 1986 of a progressive income tax rate structure makes even more compelling the case for eliminating the regressivity caused by the pay-roll tax wage ceiling.

Opponents of the elimination of the wage ceiling base their opposition on the assumption that such a change would require a massive increase in the maximum social security benefit—at current levels requiring benefits up to \$150,000 per year.<sup>70</sup> The basic contention is that subjecting the full amount of Lee Iacocca's wages to taxes must be accompanied by a dramatic increase in Lee Iacocca's social security retirement benefit.

The notion that elimination of the wage ceiling requires a massive increase in maximum benefits reflects a fundamental misunderstanding of the public function of the Social Security program as a part of a more comprehensive national retirement system.<sup>71</sup> To regard the Social Security system as if it were a self-contained system necessarily linked to actuarially fair private insurance simply is inconsistent with public policy decisions governing the overall national package of retirement security benefits. The retirement benefits of Lee Iacocca and other highly salaried employees are enhanced by a variety of tax advantages related not only to employer-sponsored pension plans but also to their individual retirement savings.<sup>72</sup> To look solely to social security benefits

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<sup>69</sup> See I.R.C. § 1 (West Supp. 1987).

<sup>70</sup> See, e.g., *Taxes Hearing*, *supra* note 18, at 68 (statement of David Keating, Executive Vice Pres., National Taxpayers Union).

<sup>71</sup> Several commentators also demonstrate the ways in which a closed-system view of social security shields the public components of the pension system from scrutiny. See, e.g., Halperin, *supra* note 10, at 161-64; Wolk, *supra* note 23, at 434-63 (arguing that "top-heavy" and discrimination rules regarding qualified pension plans fail to prevent employers from subsidizing highly compensated earners without also providing adequate protection for low income workers); N. Altman Lupu, *supra* note 2, at 61-63 (expressing concern that social security fiction of payments into individual accounts often is "misemployed" in order to "justify regressive pension plans").

<sup>72</sup> The tax advantages enjoyed by highly paid employees are not limited to retirement incentives. Favorable income tax treatment of capital gains and incentive stock options accrue to the benefit of employees in a position to exercise incentive stock options. See I.R.C. § 422A (1982 & Supp. III 1985 & West Supp. 1987); TAX EXPENDITURES, *supra* note 21, at 163, 187 (deferral of capital gains on home sales, capital gains at death). While a discussion of the cumulative effects of all tax advantages enjoyed by highly paid individuals is beyond the scope of this Article, the tax advantages attached to retirement benefits are analyzed later in this Article. See *infra* notes 120-45 and accompanying text. For detailed explanation of the tax advantages of specific components of retirement plans, see generally Halperin, *supra* note 10 (contribution limits, § 401(k) plans, distributions, withdrawals, and terminations); N. Altman Lupu, *supra* note 2 (nondiscrimination, vesting, and integration rules allow a disproportionate percentage of benefits to accrue to high income workers).

as the test of fairness for high earners, including fairness of the payroll tax wage ceiling, skews analysis—to the great disadvantage of low- and moderate-income workers. As subsequent sections of this Article detail, a more comprehensive assessment of the distribution of retirement security benefits justifies eliminating the payroll tax wage ceiling and either lowering the payroll tax rate overall or providing payroll tax relief targeted for the working poor with, at most, a small increase in the level of maximum social security benefits.

### C. *The Payroll Tax-Benefits Linkage*

More generally, the distribution of social security benefits does not justify the injustices of the social security tax. Opponents of changes at the top and bottom of the payroll tax system typically rely on the distribution of social security benefits as a complete justification for the inequities of the payroll tax.<sup>73</sup> To be sure, when the benefits of Social Security are taken into account, Social Security has, for its first fifty years at least, been a very successful redistributive program. Social security wealth (the contribution of Social Security to household wealth) is distributed among different households far more equally than privately accumulated wealth, and Social Security has reduced the concentration of total household wealth. Social Security benefits now replace about 41% of the earnings of active workers, about the same percentage as when the program began, but benefits today extend far more broadly over the labor force, to about 96% of persons aged 65 or over, as compared to 16% in 1950.<sup>74</sup> The redistributive—and therefore, in terms of

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<sup>73</sup> See, e.g., *Taxes Hearing*, *supra* note 18, at 13 (statement of Rep. John Paul Hammerschmidt).

It is often suggested that Social Security's tax rate is regressive because wages above \$40,000 are not taxed. It is only fair to add that the regressivity of the tax is compensated for by the progressivity of the benefit formula which is weighted heavily in favor of the low-wage earners.

*Id.* See also Boskin, Kotlikoff, Puffert & Shoven, *supra* note 2, at 26-27 (discussing the disparity between the present value of social security benefits received by low-income earners and high-income earners within the same generation).

<sup>74</sup> For distribution data, see *Retirement Income Security in the United States: Hearings Before the Subcomm. on Social Security and on Oversight of the House Comm. on Ways and Means*, 99th Cong., 1st Sess. 160, 168 table 3 (1985) [hereinafter *RIS Hearings*]; Maxfield & Reno, *Distribution of Income Sources of Recent Retirees: Findings from the New Beneficiary Survey*, SOC. SEC. BULL., Jan. 1985, at 7, 8-13; *Program Operations*, SOC. SEC. BULL., Sept. 1986, at 3-4; J. Tobin, *supra* note 2, at 11-13. For social security coverage statistics, see 1 DEVELOPMENTS IN AGING: 1985, 99TH CONG., 2D SESS. 21 (Comm. Print 1986) [hereinafter DEVELOPMENTS]; STAFF OF HOUSE COMM. ON WAYS AND MEANS, 99TH CONG., 1ST SESS., BACKGROUND MATERIAL & DATA ON PROGRAMS WITHIN THE JURISDICTION OF THE COMMITTEE ON WAYS AND MEANS 50-57 (Comm. Print 1985) [hereinafter WAYS & MEANS].

ability to pay, justice-enhancing—aspects of social security benefits are not, however, a complete response to the problems of social security tax injustice. First, to treat Social Security, employer retirement plans, and individual savings as complementary aspects of a comprehensive national retirement security program requires a closer look at the distributional aspects of the latter two components of the program and integration of those findings with the analysis of Social Security. Such a look will show a far less redistributive, and thus less justice-enhancing, national retirement security program than emerges from looking at social security benefits alone. Second, the widespread belief that Social Security fully replaces the income of low earners is a myth. Actual replacement rates for couples in the lowest earning quintile were 56% of preretirement wages.<sup>75</sup> Thus, social security benefits are inadequate to prevent widespread declines in living standards even of low- and moderate-wage earners upon retirement.

The role of social security benefits in combating the prospects of widespread poverty among the elderly, a concern that is treated here generally as separate from retirement security concerns, nevertheless accounts for a significant element of the redistributive quality of Social Security. To the extent that we are a nation committed to a national antipoverty “safety net” for all of our people, some portion of social security benefits might properly be regarded as attributable to our overall system of government transfers to the poor.<sup>76</sup> Surely, this is the case,

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BACKGROUND].

In addition, social security payments play a significant role in fighting poverty among the elderly. “[S]ocial security had the greatest impact upon reducing poverty other than earnings . . . . Social security income lifted approximately 9.7 million older persons out of poverty. Social security reduced the poverty rate among the aged from 51.0 percent to 14.1 percent—a reduction of 72.3 percent.” *Id.* at 88; *see also* Steuerle & Wilson, *supra* note 24, at 700 (“The Social Security program has been enormously successful in reducing the incidence of poverty among the elderly.”).

<sup>75</sup> *See* A. MUNNELL, *supra* note 4, at 20 table 2-3; *cf.* Halperin, *supra* note 10, at 161 n.13 (replacement rates for singles).

<sup>76</sup> *See* Thompson, *supra* note 10, at 1436. In FY 1985, approximately \$8.6 billion of federally financed supplemental security income (“SSI”) payments were made. Of these payments, \$6.3 billion, or 72%, went to those eligible on the basis of a disability; \$2.1 billion, or 26%, went to the aged; and \$192 million, or 2%, went to the blind. *See* STAFF OF HOUSE COMM. ON WAYS AND MEANS, 99TH CONG., 2D SESS., BACKGROUND MATERIAL & DATA ON PROGRAMS WITHIN THE JURISDICTION OF THE COMMITTEE ON WAYS AND MEANS 477 (Comm. Print 1986). Eligibility for SSI payments is detailed at 42 U.S.C. §§ 401-428 (1982 & Supp. III 1985 & West Supp. 1987). Even a portion of non-means-tested social security payments can be considered transfer payments to nonworker beneficiaries who technically have not earned the benefits. Of the total benefits paid from the OASI Trust Fund in 1984, “about 17 percent represented monthly benefits to aged survivors and disabled widows and widowers of deceased workers. Approximately 6 percent of the benefit payments [were] on behalf of children of deceased workers.” 1985 ANNUAL REPORT, *supra* note 26, at 17.

for example, whenever total government transfers to the elderly exceed 100% of inflation-adjusted final preretirement wages. To divorce this goal of social security benefits in general from the wage replacement goal of retirement security policy not only calls into question the widespread contentions that the benefits structure of social security fully redresses its tax unfairness, but also weakens the case for wage-based taxation as the mechanism for financing benefits.<sup>77</sup>

### III. EMPLOYER-PROVIDED PENSIONS

As noted above, many oppose the elimination of the payroll tax wage ceiling on the grounds that such elimination would require that government-provided retirement benefits for high-wage employees far exceed the current social security maximum. Surely, the most direct response to this opposition is that the government already provides such additional benefits, for example, in the form of tax benefits, labelled in the federal budget "tax expenditures," for employer-provided pensions. The public component, both in subsidizing and regulating employer-provided pensions, makes the common label "private pensions" quite misleading. Under the income tax, employer-provided pensions may qualify for special tax treatment; employers' payments into a pension plan are immediately deductible by employers but are not currently includable in the income of the employees. In addition, the earnings of pension funds are not taxed as earned but rather accumulate free of income tax.<sup>78</sup> This income tax treatment is clearly more favorable than that given to cash compensation, most notably because pension funds accumulate earnings tax-free in contrast to the normal current income taxation of investment income, but also because the deferral of taxation of compensation until retirement may permit taxation at lower rates.<sup>79</sup>

According to recent estimates of tax expenditures, the largest tax expenditure for individuals by far is the net exclusion for employer-sponsored pension contributions and earnings. In 1985, for example,

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<sup>77</sup> For a discussion of the tax-transfer perspective on social security benefits versus the insurance view, see Thompson, *supra* note 10, at 1436-37.

<sup>78</sup> See Halperin, *supra* note 10, at 159-60; N. Altman Lupu, *supra* note 2, at 16-17. These special tax rules for qualified pension plans result in revenue loss estimated at \$49.3 billion in 1988 and expected to rise to \$67.5 billion in 1992. See TAX EXPENDITURES, *supra* note 21, at 313-14.

<sup>79</sup> See Halperin, *supra* note 10, at 160 n.6. Through revisions of the income tax rate schedules, the Tax Reform Act of 1986 may reduce the advantages of lowering an employee's marginal tax rate during retirement. If such rate revision is permanent, the 1986 Act may eliminate or decrease the shifting of income to a lower postretirement rate. See TAX EXPENDITURES, *supra* note 21, at 314. For the argument that a critical element of retirement savings involves shifting the rate of tax, see Halperin, *supra* note 59, at 519-20.



tax expenditures for employer-provided pensions were estimated to cost the Treasury nearly \$53 billion, more than double the next largest tax expenditure item, the \$25.5 billion lost because of the home mortgage interest deduction.<sup>80</sup> In fiscal 1987 (before the effects of the 1986 Tax Reform Act are taken into account), the revenue loss attributable to employer pensions has been estimated at \$61.3 billion.<sup>81</sup> The effects of the Tax Reform Act of 1986 (principally the reduction of the tax rate) are estimated to reduce this amount to \$49.3 billion for fiscal 1988, a number that is expected to grow to \$67.5 billion by fiscal 1992.<sup>82</sup> Even if these estimates somewhat overstate the size of the government subsidy,<sup>83</sup> the tax incentive for employer-provided pensions undoubtedly constitutes an extremely significant aspect of this nation's retirement security program.

Although there are nontax reasons<sup>84</sup> for employers to establish pension plans and, in fact, some employer plans predate the income tax, tax incentives to employer-provided pensions, at a minimum, have produced a substantial shift away from other savings.<sup>85</sup> Private pension

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<sup>80</sup> See STAFF OF JOINT COMM. ON TAXATION, 99TH CONG. 2D SESS., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1987-1991, at 18 table 3 (Comm. Print 1986); *Estimates of Federal Tax Expenditures for Fiscal Years 1984-1989*, 25 TAX NOTES 721, 727 table 1 (1984); see also TAX EXPENDITURES, *supra* note 21, at 155, 159, 313. For the most recent figures, see JT. COMM. ESTIMATES, *supra* note 19, at 10-17 table 1 (compiling tax expenditures for FYs 1988-1992).

<sup>81</sup> See TAX EXPENDITURES, *supra* note 21, at 313; see also Halperin, *supra* note 10, at 195 n.118 (estimating revenue loss to be over \$67 billion).

<sup>82</sup> See JT. COMM. ESTIMATES, *supra* note 19, at 15 table 1. The comparable numbers for home mortgage interest are \$28.9 billion (1988) and \$32.1 billion (1992). See *id.* at 12 table 1.

<sup>83</sup> There are two reasons that tax expenditure estimates might be overstated. First, such calculations are not on a present value basis. See A. MUNNELL, *supra* note 4, at 46. Second, the estimates are not limited to the exclusion of investment income. See Halperin, *supra* note 59, at 551-52.

<sup>84</sup> See, e.g., J. ROSENBLOOM & G. HALLMAN, *supra* note 16, at 13-18 (employee welfare, corporate efficiency, attracting capable employees, labor demands, governmental pressures, and advantages of group insurance).

<sup>85</sup> See SENATE SPECIAL COMM. ON AGING, 98TH CONG., 2D SESS., THE EMPLOYEE RETIREMENT SECURITY ACT OF 1974: THE FIRST DECADE, at 201-03 (Comm. Print 1984) [hereinafter FIRST DECADE]. For a discussion of the debate regarding whether retirement savings replace or increase savings, see generally W. Andrews & D. Bradford, Savings Incentives in a Hybrid Income Tax (Oct. 30-31, 1986) (unpublished paper presented at the Brookings Tax Conference, Washington, D.C.); A. Munnell, Comments on William D. Andrews and David Bradford "Incentives to Save in a Hybrid Tax System" (Oct 30-31, 1986) (unpublished paper presented at the Brookings Tax Conference, Washington, D.C.). See generally *Tax Reform Proposals-XIII: Hearings Before the Senate Finance Comm.*, 99th Cong., 1st Sess. 41-42 (1985) [hereinafter *Proposals*] (comparing relative effect on savings of pensions and IRAs); 1 DEVELOPMENTS, *supra* note 74, at 97-103 (summarizing debate, with focus on IRAs); Break, *supra* note 55, at 59-71 (discussing theoretical approaches to and empirical studies of the effect of social security on savings). For tax expenditure calculations, see generally JT. COMM. ESTIMATES, *supra* note 19, at 2-3. If retirement savings substi-

assets total more than \$1 trillion and these assets now account for about one-half of all available U.S. investment capital.<sup>86</sup> It is therefore essential to evaluate the distribution of the benefits and burdens of this major element of government retirement security policy.

The distribution of government benefits to employer-provided pensions contrasts significantly with the targeting of social security benefits to low- and moderate-income workers. The revenue loss attributable to private pensions has been estimated to benefit high-income workers disproportionately, and the distribution of benefits from private pension plans is skewed in the same direction. Only 56% of nonagricultural workers are covered by employer-sponsored pension plans, and employees with high earnings are the most likely to be covered. In 1983, only 68% of employees with earnings below \$25,000 were covered, compared to 82% with earnings of \$25,000 or more.<sup>87</sup> Only the top quintile of the income distribution receives as much private pension income as social security income. Notwithstanding the recent expansion of pension fund assets, of those people who had recently retired, half of the married couples and two-thirds of the unmarried persons received no more than \$100 a month in 1982, and many of these received no private pensions.<sup>88</sup> This state of affairs is not especially surprising, given the nature of permissible limitations that employers may place on the distribution of pension benefits. These include length of work requirements before benefits vest,<sup>89</sup> the inability of workers to move benefits to new jobs,<sup>90</sup> and the so-called integration rules,<sup>91</sup> which, in determining

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tute for general savings, the transfer probably occurs with all types of tax-favored retirement vehicles. See Sheppard, *AGE Conference Explores Adequacy of Private Pension System*, 31 TAX NOTES 335, 335 (1986) (citing B. Bosworth, Senior Fellow, Brookings Institute) ("[B]etween 1980 and 1983, one percent of national savings was shifted to the IRA and Keogh plan form, while national savings fell.").

<sup>86</sup> See *RIS Hearings*, *supra* note 74, at 183; see also Sheppard, *Ways & Means Subcommittees Consider Retirement Income Security*, 28 TAX NOTES 391, 391 (1985). See generally E. STEUERLE, *supra* note 34, at 15-18 (listing and discussing categories of individual assets).

<sup>87</sup> See *Proposals*, *supra* note 85, at 29; see also EBRI, IRAs, *supra* note 20, at 9 table 4 (breaking down pension coverage by earnings groups); Snyder, *Pension Status of Recently Retired Workers on Their Longest Job: Findings from the New Beneficiary Survey*, SOC. SEC. BULL. Aug. 1986, at 5, 9-10 (breaking down pension coverage by earnings groups, gender, and type of employment).

<sup>88</sup> See Maxfield & Reno, *supra* note 74, at 12-13; see also Halperin, *supra* note 10, at 169.

<sup>89</sup> See I.R.C. § 411(a), (d)(1) (1982 & Supp. III 1985 & West Supp. 1987).

<sup>90</sup> See I.R.C. § 401(a)(14) (1982 & West Supp. 1987).

<sup>91</sup> I.R.C. § 401(a)(5) (West Supp. 1987); Rev. Rul. 83-110, 1983-2 C.B. 70, and Rev. Rul. 71-446, 1971-2 C.B. 187 provide guidelines for calculating the portion of an employer's social security payment (made on behalf of an individual employee) that may be taken into consideration when determining eligibility for pension benefits under the law prior to the 1986 guidelines. A further problem with such integration formulas

whether an employer meets the nondiscrimination requirements applicable to private pensions, effectively treat social security benefits as if they were provided by employers. Even so, vested pension benefits are distributed more widely across income brackets than other forms of savings, including IRAs.<sup>92</sup>

In any event, taking into account the distribution of tax reductions or payments of employer-provided pensions, produces a very different picture of our national retirement system than does considering the distribution of social security taxes and benefits alone. The Tax Reform Act of 1986 contains a major revision of private pension rules<sup>93</sup> in an effort better to correlate the conditions for pension eligibility for favored tax treatment with retirement security goals, but considerable uncertainties about the effectiveness of that legislation remain. Critics are

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is that they have assumed that social security replaces the preretirement earnings of low and moderate-income workers. Yet, "Social Security benefits amount to only 35 percent to 47 percent of preretirement earnings for individuals and couples in the bottom two quintiles of the income distribution." FIRST DECADE, *supra* note 85, at 178; *see also* A. MUNNELL, *supra* note 4, at 20. Thus, lower paid workers may be denied any real participation in pension benefits based on the inaccurate premise that their retirement needs can be met solely through social security.

<sup>92</sup> *See infra* note 196. EBRI calculations are for percentages of workers covered by a pension plan. The percentages of total vested workers across income groups, presented in the table below, can be compared to the percentages of workers with other forms of retirement savings, although neither set of figures gives a sense of the magnitude of actual retirement benefits to be paid. *See id.*

Employment, Coverage, and Vesting Percentages:  
Distribution by Earnings for Nonagricultural  
Wage and Salary Workers, May 1983

Earnings	% Employ- ment	% of <sup>a</sup> Coverage	% of Total <sup>a</sup> Vesting
Total	100.00%	100.00%	100.00%
\$1-4,999	12.47	5.14	1.30
\$5,000-9,999	19.08	12.13	7.33
\$10,000-14,999	22.20	21.80	19.87
\$15,000-19,999	16.32	19.89	21.28
\$20,000-24,999	12.81	17.22	20.43
\$25,000-29,999	6.87	9.21	11.04
\$30,000-49,999	8.23	11.71	14.75
\$50,000 and over	2.01	1.89	4.01

Source: *Distribution and Economics of Employer-Provided Fringe Benefits: Hearings Before the Subcomm. on Social Security and Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means*, 98th Cong., 2d Sess. 638, 641 table 1 (1984) (citing preliminary EBRI tabulations from the *EBRI/Department of Health and Human Services, Current Population Survey* pension supplement) (statement of Dr. Emily S. Andrews, EBRI Research Associate).

a. Percentages exclude 9.0% of employees whose earnings are not reported.

<sup>93</sup> *See* I.R.C. §§ 401-416 (1982 & Supp. III 1985 & West Supp. 1987).

already complaining that the 1986 legislation is inadequate from a retirement security perspective,<sup>94</sup> but this criticism ultimately may reflect inherent difficulties in relying on voluntary employer-provided pensions as a substantial source of retirement income for rank and file workers.

A. *The Precarious Nature of Redistributive Efforts Through Employer-Provided Pension Plans*

The formulation of policy recommendations to ensure that employer-provided pension plans meet national retirement security goals is extremely difficult. Regulation of employer-provided pensions largely takes the form of conditions imposed on the granting of favorable tax treatment for such pension plans.<sup>95</sup> To use conditional tax incentives as a principal mechanism for regulation poses an immediate dilemma because of the voluntary nature of employer-provided pension plans. On the one hand, the creation of pension regulations always reflects a concern that making qualification too difficult will inhibit the establishment of pension plans. On the other hand, there is little public gain in subsidizing employer plans that provide minimal or no benefits to low- and moderate-income workers. In short, efforts to make voluntary pension plans better serve public retirement policy by targeting government subsidies more toward low- and moderate-income workers may have the effect of reducing the overall number of plans and, perhaps, the totality of benefits provided to those classes of workers for whom such protection seems most essential.<sup>96</sup> The prospect of such circumstances calls into question the appropriateness of relying on income-tax-preferred employer-sponsored pension plans to supply a major component of retirement security.

First, it is extremely unlikely that low- and moderate-income workers, whose wages have already been reduced by more than 14% for social security taxes, would be willing to substitute additional deferred compensation for current cash compensation on a dollar-for-dollar-basis, even if the deferral is subsidized through income tax reductions. High-wage earners, however, in exchange for a tax reduction, might well be willing to make such a tradeoff between current cash compen-

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<sup>94</sup> See N. Altman Lupu, *supra* note 2, at 64-73.

<sup>95</sup> See, e.g., I.R.C. § 401 (1982 & Supp. III 1985 & West Supp. 1987).

<sup>96</sup> See *RIS Hearings*, *supra* note 74, at 388-95 (statements of C. David Hurd, Ass'n of Private Pension & Welfare Plans, and James Short, Vice-President, Benefits Administration, U.S. Steel Corp., on behalf of the ERISA Industry Committee); EBRI, IRAs, *supra* note 20, at 9 table 5 (showing distribution of pension, § 40(k), and IRA participants by earnings), 12 table 9 (showing projected average annuity value of IRA assets at age 67).

sation and deferred compensation.<sup>97</sup> The consequent creation of a massive tax subsidy for retirement security limited to high-income wage earners, however, would be inconsistent with the *public* goals of a national retirement security policy.

Second, this natural distribution of private pension benefits toward high-wage earners has been skewed further by the existence of progressive rates under the income tax: the exclusion of wages from income is worth more to a high-bracket than a low-bracket taxpayer.<sup>98</sup> The 1986 lowering of tax rates and flattening of the tax rate schedule will mitigate this factor somewhat, but there will remain a substantially greater incentive for a high-income taxpayer, paying as much as a 33% marginal rate under the 1986 legislation, to reduce taxes than for a lower-earning taxpayer paying a 15% marginal rate. Moreover, borrowing from pension plans to finance pension savings has the potential to undermine the effectiveness of the tax expenditure for retirement savings. This ability, too, disproportionately favors high earners.<sup>99</sup>

In this context, it is clear that the private pension system depends upon encouragement by high-earning employees for the creation and maintenance of employer-sponsored retirement plans that redistribute to low- and moderate-income workers at least a portion of the tax savings that otherwise would benefit high earners.<sup>100</sup> This goal is made more difficult, however, whenever there exist other opportunities for high wage earners to achieve equivalent tax savings without the kinds of restrictions applicable to employer-provided pension plans. If, for example, high-income workers are able to achieve comparable tax bene-

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<sup>97</sup> There is some evidence that high-income workers are predisposed to save more of their income in the short- or medium-term. See Friend, *Effects of Taxation on Financial Markets*, in *THE PROMISE OF TAX REFORM*, *supra* note 34, at 87, 89.

<sup>98</sup> One commentator has noted:

An inescapable feature of such deferral is that it provides greater benefits to taxpayers with high marginal rates. For example, consider two employees: A is in the 50% bracket and B is in the 14% bracket. If A received \$1,000 in compensation and invested what remained after taxes in a 10% savings account, at the end of thirty years the account would contain \$2,161 after taxes. If instead A's employer placed \$1,000 in a qualified plan for A's benefit that earned the same 10% return, at the end of thirty years A would have \$8,725 after taxes. The difference, \$6,564, is essentially a government subsidy paid to A because A's employer contributed \$1,000 to the plan. This subsidy gives A an effective taxable rate of return of 20%. A similar computation for B reveals a difference of \$4,787. This amounts to giving B an effective taxable rate of return of 11.6%. The reduction in effective tax rate is clearly greater for A than for B.

Wolk, *supra* note 23, at 429 (footnotes omitted).

<sup>99</sup> See *infra* notes 204-09 and accompanying text.

<sup>100</sup> For a discussion of the need to trade off tax advantages to induce participation by low-income workers, see generally Wolk, *supra* note 23.

fits through individual savings, they will be far less inclined to pressure employers to create and maintain pension arrangements. Tax benefits for employer-provided plans therefore have been available for sums substantially greater than similar tax benefits available for individual retirement savings by high-income workers. In light of these pressures, the vitality of this nation's private pension system is somewhat surprising. Maintenance of a vital employer-provided pension system seems to depend on employers themselves having an important stake in creating and nurturing a pension plan. For the tax stimulant to work at all, it seems essential that employers prefer paying a dollar of deferred compensation into an employer-funded plan to paying a dollar of cash compensation.

This requirement is frequently satisfied under the present system. In addition to the possible benefits derived from controlling a pension fund, the ability of employees to exclude qualified deferred compensation from income also provides an incentive for employers to substitute deferred compensation for cash. An employee, for example, who is subject to a 28% marginal tax rate should prefer \$73 of tax-free fringe benefits to \$100 of taxable wages. Employers, needless to say, would prefer to pay \$73 rather than \$100 of compensation. Although the benefit of deferring tax on employer contributions to pension plans is not always equivalent in present value terms to exempting compensation from tax,<sup>101</sup> the attendant tax savings nevertheless should move both employers and employees toward the tax-preferred form of compensation. How far they will move is not obvious, however, and will depend, in part, on opportunities for other nontaxable fringe benefits and on employees' preferences with respect to such alternatives as well as their preferences for deferred versus cash compensation. Employers' preferences for deferred compensation can be further stimulated if the government provides employers with both some protection from downside risks and some ability to capture a share of any exceptionally beneficial performance of invested pension funds. Government involvement is necessary because the existence of a pension fund, without more, often will provide the employer with control over significant amounts of funds. Such control would not occur if the bulk of the deferred wages were paid as cash compensation.<sup>102</sup> Finally, one should not lose sight of the

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<sup>101</sup> For examples of cases where this equivalence holds, see M. GRAETZ, *supra* note 28, at 342-45. See generally Halperin, *supra* note 59 (suggesting a new approach to deal with deferred compensation arrangements); Warren, *supra* note 59 (discussing conditions under which deferral or acceleration will not affect present value).

<sup>102</sup> See A. MUNNELL, *supra* note 4, at 93 table 5-1 (listing private pension assets held in trust or by life insurers in selected years between 1945 and 1980); *infra* notes 159-62 and accompanying text (discussing question of who benefits upon termination of

fact that employers often have nontax reasons for preferring deferred compensation.<sup>103</sup>

### B. *The Regulation of Employer-Provided Pension Plans*

Given the significant role of tax advantaged pension plans in fulfilling this nation's retirement security goals, the regulation of employer-provided pension plans should reflect two principal concerns: (1) does the distribution of benefits from such plans comport sufficiently with the public function of ensuring retirement security, especially for low- and moderate-income workers; and (2) does the distribution of risks associated with employer-provided plans sufficiently protect workers? Concerns about the distribution of benefits involve whether employees actually will receive benefits at retirement under plans maintained by their employers and whether the benefits received will be adequate with respect to the wage replacement goal of retirement security. The law reflects these concerns in the form of rules (1) requiring vesting of retirement benefits after the passage of a specified period of time,<sup>104</sup> (2) prohibiting discrimination of pension benefits in favor of high-income workers;<sup>105</sup> (3) permitting "integration" of employer-provided pension plans and social security;<sup>106</sup> (4) limiting levels of maximum benefits<sup>107</sup> and requiring certain levels of minimum benefits,<sup>108</sup>

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pension plans).

<sup>103</sup> It is generally accepted that deferred compensation contingent on years of service increases the stability of the workforce. See FIRST DECADE, *supra* note 85, at 181-83. Additionally, employers use the assets built up in many retirement plans to purchase employer securities or as a potential investment source if the fund's rate of return is larger than that required to fund employees' future benefits. For a discussion of employer terminations and use of plan assets, see generally *Moratorium on Pension Plan Reversions, 1984: Hearing Before the Subcomm. on Labor of the Senate Comm. on Labor and Human Resources*, 98th Cong., 2d Sess. (1984). The existence of a pension plan should also make it easier for employers to retire older workers, an advantage that has become of greater importance today in light of 1986 legislation barring retirement solely because of age. See J. ROSENBLOOM & G. HALLMAN, *supra* note 16, at 15 (stating that retirement plans can be used "to facilitate the systematic retirement of older employees . . .").

<sup>104</sup> See I.R.C. § 411(a) (1982 & Supp. III 1985 & West Supp. 1987); see also EMPLOYEE BENEFIT RESEARCH INSTITUTE, ISSUE BRIEF NO. 51, PENSION VESTING STANDARDS 1-4 (1986) [hereinafter EBRI, VESTING].

<sup>105</sup> See I.R.C. §§ 401(a)(4), (a)(5), (a)(20), 410 (West Supp. 1987); see also Treas. Reg. § 1.410(b)-1(d)(2) (1977) (describing rules applying a fair cross section test to determine if a pension plan impermissibly discriminates in the percentage of benefits paid to highly compensated employees).

<sup>106</sup> See I.R.C. § 401(l) (West Supp. 1987); see also Rev. Rul. 71-446, 1971-2 C.B. 187 (pre-1986 law requirements); Treas. Reg. § 1.401-3(e) (as amended in 1971); A. MUNNELL, *supra* note 4, at 55-59 (discussing integration rules).

<sup>107</sup> See I.R.C. § 415 (1982 & Supp. III 1985 & West Supp. 1987).

<sup>108</sup> See I.R.C. § 401 (1982 & Supp. III 1985 & West Supp. 1987); §§ 410, 414

(5) limiting employees' ability to withdraw or borrow against pension assets;<sup>109</sup> and (6) governing portability of pension benefits when employees change employers.<sup>110</sup>

The law reflects concerns about the distribution of economic risks through (1) federal insurance for pension benefits;<sup>111</sup> (2) rules regarding termination of employer-provided plans;<sup>112</sup> (3) restrictions on employees' rights to borrow against or withdraw pension benefits in case of preretirement economic hardship;<sup>113</sup> (4) employers' abilities to select defined contribution versus defined benefit plans;<sup>114</sup> and (5) to some extent, rules governing portability of pension benefits.<sup>115</sup> It is neither feasible nor desirable to discuss each of these issues in detail in this Article, but a brief overview of the major issues should convey a sense of the policies governing the overall distributions of benefits and risks.

The distribution of both benefits and risks of employer-provided plans are unsatisfactory from the perspective of a unified national retirement security program. Most of these rules were originally conceived as mechanisms to limit potential tax abuses that would concentrate pension tax benefits in the hands of a few high-salaried workers.<sup>116</sup> This concern operated independently of concerns over retirement security per se. It was not until 1974 that Congress restricted

(West Supp. 1987).

<sup>109</sup> See I.R.C. § 72(o) (special rules for distribution from qualified plans), § 72(p) (borrowing) (1982 & Supp. III 1985 & West Supp. 1987); §§ 72(t), 403(b)(10) (withdrawals) (West Supp. 1987).

<sup>110</sup> See I.R.C. §§ 402(a)(5), 403(a)(4), 408(d)(3) (1982 & Supp. III 1985 & West Supp. 1987) (permitting "rollover of benefits").

<sup>111</sup> See 29 U.S.C. §§ 1301-1309, 1321-1323, 1341-1348, 1361-1368, 1381-1461 (1982 & Supp. III 1985 & West Supp. 1987), § 1349 (West Supp. 1987) (providing for a plan termination insurance program); see also *FIRST DECADE*, *supra* note 85, at 147-51 (plan termination insurance). Regardless of whether plan terminations occur because of overfunded plans or failing businesses, employees may not receive the benefits for which they bargained. "In 1979, there were ten overfunded plan terminations totalling \$18 million." *Id.* See also *Overfunded Pension Plans: Joint Hearing Before the House Select Comm. on Aging and the Comm. on Education and Labor*, 99th Cong., 1st Sess. 129 (1985) [hereinafter *Overfunded Pension Plans*]. By 1983 the number had risen to 151, totalling \$2.1 billion. For detailed examples of the negative impact of pension terminations on worker pension wealth despite PBGC-provided insurance, see Ippolito, *Issues Surrounding Pension Terminations for Reversion*, 5 J. AM. TAX POL'Y 81, 84-85 (1986).

<sup>112</sup> See I.R.C. § 411(d)(3) (1982 & West Supp. 1987).

<sup>113</sup> See I.R.C. §§ 72(t)(2)(B), 403(b)(11)(B) (West Supp. 1987) (addressing medical expenses and hardship withdrawals respectively); see also I.R.C. § 72(o) (special rules for distribution from qualified plans), § 72(p) (borrowing) (1982 & Supp. III 1985 & West Supp. 1987); §§ 72(t), 403(b)(10) (withdrawals) (West Supp. 1987).

<sup>114</sup> See I.R.C. § 415 (1982 & Supp. III 1985 & West Supp. 1987).

<sup>115</sup> See I.R.C. §§ 402(a)(5), 403(a)(4), 408(d)(3) (1982 & Supp. III 1985 & West Supp. 1987) (permitting "rollover of benefits").

<sup>116</sup> See N. Altman Lupu, *supra* note 2, at 4-9, 19-22.



tax benefits for employer-provided pensions to ensure that these plans actually provide retirement security for the moderate-income workers they ostensibly cover.<sup>117</sup> In 1982, Congress adopted restrictions on so called "top heavy plans" that seemed responsive predominantly to concerns about the potential for tax abuses. The 1986 legislation, however, has reaffirmed an ongoing congressional effort to conform employer-provided pension plans to national retirement security policies.<sup>118</sup>

In evaluating the distribution of both benefits and risks of employer-provided plans, one must remain mindful that relying upon tax inducements to encourage voluntary plans necessarily will produce compromises. Congress will be wary of harsh rules in an effort to maintain voluntary plans as a viable and important element of retirement security for this nation's workers. At the same time, however, Congress will endeavor to ensure that the distribution of benefits and curtailment of risks to low- and moderate-income workers justifies the public subsidy to employer plans.<sup>119</sup> As long as voluntary tax-preferred employer plans remain the implementation mechanism for this aspect of national retirement income security policy, the applicable regulatory conditions must provide encouragement to both high-income workers and employers to maintain such plans. Restrictions on alternative tax-favored means of individual savings for retirement (or other purposes) by high-income workers ultimately may also prove an important element in the effectiveness of the tax stimulus to employer-provided pension plans.

### 1. Distribution of Benefits from Employer-Provided Plans

Notwithstanding the inherent difficulties of implementation, a public subsidy to employer-provided pension plans can be defended only if such plans contribute substantially and fairly to the wage replacement goal of public retirement security policy. This means that such plans must assist significantly in maintaining preretirement lifestyles of low- and moderate-income workers even if they also sustain postretirement lifestyle maintenance for high-income retirees. Historically, private pension plans have been able to obtain substantial tax

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<sup>117</sup> See Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 29 U.S.C. §§ 1001-1461 (1982 & Supp. III 1985 & West Supp. 1987)); Halperin, *supra* note 10, at 163; N. Altman Lupu, *supra* note 2, at 23-24.

<sup>118</sup> See 2 CONF. REP., *supra* note 34, at 424-27. For a discussion of the operation of top-heavy plan rules and the changes made by the 1986 Tax Reform Act, see N. Altman Lupu, *supra* note 2, at 30-43.

<sup>119</sup> See J. ROSENBLOOM & G. HALLMAN, *supra* note 16, at 262-97 (overview of pension plans).

benefits that inure to high-income workers, even though they have failed to provide adequate benefits to moderate-income workers.<sup>120</sup> A variety of rules have evolved over the years in an effort to ensure more adequate distribution of benefits. The most important of these are requirements relating to vesting, nondiscrimination, and integration with Social Security.

Vesting requirements provide an excellent illustration of the basic regulatory tensions. For Social Security, vesting means that a worker is entitled to full minimum social security benefits immediately after paying social security taxes for a minimum number of earnings quarters.<sup>121</sup> This nonforfeitable right to social security benefits moves with the employee across jobs and across employers. In contrast, nonforfeitable rights to employer-provided pension benefits do not accrue until the employee has worked for the same employer for a specified period of time during which the employer has made pension contributions on that employee's behalf.<sup>122</sup> In addition, changing jobs may trigger the payment of vested pension benefits and thereby eliminate their role as a source of income during retirement years.<sup>123</sup> Daniel Halperin has noted the tension inherent in such a scheme: If an employer is not required to have a pension plan, what justification—other than the potential for tax abuse—exists for minimum vesting requirements? On the other hand, if pension plan contributions are substitutes for cash compensation, how can one justify anything other than immediate full vesting?<sup>124</sup>

Although the Treasury Department long had attacked what it regarded as excessive delays in vesting as violating nondiscrimination standards,<sup>125</sup> Congress did not require a minimum vesting schedule until it enacted the Employee Retirement Income Security Act of 1974 ("ERISA").<sup>126</sup> ERISA contained three alternative minimum vesting schedules. The first schedule required the full vesting of benefits upon the completion of ten years of job service with the same employer (ten-

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<sup>120</sup> For example, in 1977, 66% of the tax benefits for employer plans went to the 16% of employees with incomes over \$20,000. See A. MUNNELL, *supra* note 4, at 45-46. See generally N. Altman Lupu, *supra* note 2, at 19-30 (history of nondiscrimination provisions).

<sup>121</sup> The number of earnings quarters needed has changed over time, so different standards apply to different age groups. See 42 U.S.C. § 413 (1982 & Supp. III 1985).

<sup>122</sup> For an explanation of the three primary vesting rules instituted under ERISA, see EBRI, VESTING, *supra* note 104, at 2-4.

<sup>123</sup> See Halperin, *supra* note 10, at 178.

<sup>124</sup> See D. Halperin, Unpublished Class Materials for Course on Retirement Security, Yale Law School (Spring 1986).

<sup>125</sup> See N. Altman Lupu, *supra* note 2, at 18-21.

<sup>126</sup> Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 29 U.S.C. §§ 1001-1461 (1982 & Supp. III 1985 & West Supp. 1987)).

year cliff vesting). The second schedule provided for 25% vesting beginning after the completion of five years of service, increasing to 100% after fifteen years of service. The third schedule mandated partial vesting of 50% after ten years of service with an additional 10% of the benefit vesting each year until 100% vesting occurred after fifteen years of service.<sup>127</sup> The latter option was limited to plans that factor in age as well as service years. Beginning in 1982, so-called "top heavy plans" were required to meet three-year cliff vesting or six-year gradual vesting requirements.<sup>128</sup>

Conditioning the receipt of pension benefits on such length of service requirements is most detrimental to marginal or unconventional workers. Part-time workers (those working 500-1000 hours per year) can be entirely excluded under current pension participation standards.<sup>129</sup> Further, as the workforce becomes more mobile, increasing numbers of workers will forfeit pension contributions made on their behalf because of insufficient periods of employment with the same employer. Vesting requirements also tend adversely to affect low income workers. Finally, vesting requirements operate particularly to the detriment of minorities and women because of the demographics of the career patterns of these groups. Minorities have particular difficulties accumulating pension benefits because of their mobility, high rates of unemployment, and employment in jobs not covered by plans.<sup>130</sup> Similarly, the average woman stays at a job only 3.7 years, while the average man stays at a job 5.1 years.<sup>131</sup> Stringent vesting requirements cre-

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<sup>127</sup> See I.R.C. § 411 (1982 & Supp. III 1985), amended by I.R.C. § 411 (West Supp. 1987); EBRI, VESTING, *supra* note 104, at 2-3.

<sup>128</sup> I.R.C. § 416(b) (1982 & Supp. III 1985).

<sup>129</sup> See I.R.C. § 410(a)(4) (1982); COMING OF AGE, *supra* note 3, at 34.

<sup>130</sup> See *The Black Elderly in Poverty: Hearing Before the House Select Comm. on Aging*, 99th Cong., 1st Sess. 4-5 (1985); COMING OF AGE, *supra* note 3, at 34. The gap between salaries of white males and salaries of minorities and women, part-time and household work patterns, and greater mobility combine to create inadequate retirement coverage for many. For example, "[w]omen make up 60% of the part-time workers . . . three-fifths of them have over one year of service, 21% of them have five years or more, yet [they] can be excluded if they work less than 1,000 hours a year." *RIS Hearings*, *supra* note 74, at 493. Similarly, the types of jobs dominated by disproportionate numbers of minorities and women are characterized by low wages and inadequate benefits. See Root, *Employee Benefits and Social Welfare: Complement and Conflict*, 479 ANNALS 101, 115-17 (1985).

<sup>131</sup> See *RIS Hearings*, *supra* note 74, at 493; EBRI, VESTING, *supra* note 104, at 11 (noting that job tenure has decreased to a median of 4 years for men and 1.5 years for women). It should be noted that, in practice, stringent vesting requirements have deprived important numbers of low- and moderate-income employees of any employer-provided pension benefits. See Snyder, *supra* note 87, at 10 table 7, 11 (noting that "industry and years elapsed since [an employee's] longest job were most critical"). "[O]ver one million more men and 766,000 more women would have been vested in 1985 had there been a 5-year vesting standard." EBRI, VESTING, *supra* note 104, at 9.

ate a high rate of forfeited contributions that may be distributed among remaining plan participants, and have had the effect of redistributing pension contributions from lower paid employees to higher paid employees with more years of service. Strict vesting requirements reduce employer costs and further concentrate the tax advantages received by high-income employees. For these reasons, pension vesting requirements may serve to reverse some of the progressive redistributive effects of social security benefits.<sup>132</sup>

The Tax Reform Act of 1986 ("the 1986 Act") replaces the three minimum vesting standards of ERISA with two new minimum requirements. Under the new rules, an employer must either fully vest pension benefits in workers after five years of service or vest 20% of benefits each year beginning at the end of three years of service so that such employees will be fully vested at the end of seven years of service.<sup>133</sup> These requirements represent a substantial improvement on the ERISA standards. If a five-year standard had been applicable in 1985, almost 2 million additional workers would have been entitled to vested benefits—a 7% increase in the number of men and a 10% increase in women.<sup>134</sup> Greater coverage requirements would have made 6.3 million more women eligible for pension benefits than prior law.<sup>135</sup> The 1986 vesting rules retain these length of employment conditions as a means of promoting stability in the workforce and avoiding the additional administrative costs of an immediate vesting standard. It remains to be seen, however, whether the 1986 rules will attain either the retirement

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<sup>132</sup> A simple example of an employer-defined contribution plan demonstrates the wealth transfer from low-paid, nonvested employees to high-paid, vested employees participating in the plan. The example assumes that employee D leaves the employer before benefits vest and is replaced by employee E who will not begin to participate for three years.

Compensation	Acct. Balance First Year	Contrib. 2nd Year	Forfeiture Allocated	Acct. Bal.	% of Total
A \$100,000	\$16,189	\$16,051	\$ 744	\$32,984	62.8
B 50,000	7,017	6,948	372	14,337	27.3
C 20,000	2,529	2,501	149	5,179	9.9
D 10,000	1,265	—	—	—	—
E 10,000	—	—	—	—	—
	<u>\$27,000</u>	<u>\$25,500</u>	<u>\$1,265</u>	<u>\$52,500</u>	<u>100.0</u>

Source: Wolk, *supra* note 23, at 450 table III.

Although forfeitures from defined benefit plans may not be used to increase other participants' benefits, regardless of plan type, forfeitures are advantageous to employers. The employer can use such forfeitures to reduce contributions to the plan or to offset administrative expenses. See 2 CONF. REP., *supra* note 34, at 442.

<sup>133</sup> See I.R.C. § 411(a)(2) (West Supp. 1987).

<sup>134</sup> See EBRI, VESTING, *supra* note 104, at 9.

<sup>135</sup> Only 11.5% of women over 65 have private pensions. See RIS Hearings, *supra* note 74, at 492-95.

security or tax justice advantages of an immediate vesting rule.

The 1986 Act also strengthens the nondiscrimination standards and the rules permitting integration of employer-provided pension plans and Social Security.<sup>136</sup> In theory, the nondiscrimination requirements are present in the Code for the purpose of inhibiting tax abuse prospects and ensuring that employer-provided pensions satisfy retirement income security goals. These requirements operate by permitting pension plan contributions and earnings to qualify for tax-advantaged treatment only if a substantial number of lower paid employees participate in the plan. The basic requirement is stated as a minimum level of coverage necessary for a plan to qualify for favorable tax treatment.<sup>137</sup>

Prior to the 1986 legislation, nondiscrimination coverage requirements could be met by satisfaction of any of three alternative tests.<sup>138</sup> The 1986 legislation replaces these tests with a combination of a percentage coverage test and a minimum employee coverage requirement. Specifically, under the 1986 Act, the nondiscrimination requirement will be satisfied if the percentage of employees covered under the plan who do not earn high wages is at least 70% of the highly compensated employees covered under the plan<sup>139</sup> and if the lesser of fifty employees or 40% of all employees are covered by the plan.<sup>140</sup> The 1986 Act, however, does not eliminate the ability of employer-provided plans to qualify for favorable tax treatment even though they cover a lower percentage of middle-income workers than of high-income workers. Although the 1986 changes in the nondiscrimination requirements were designed to confine tax advantages for employer pensions to those plans that meet retirement security goals, it seems unlikely that this tightening of the rules will prove adequate. A number of important exceptions to the nondiscrimination requirements remain,<sup>141</sup> and coverage of low- and moderate-income employees remains restricted by the ability of em-

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<sup>136</sup> See I.R.C. §§ 410(b)(1)(B), 411(b)(c) (West Supp. 1987).

<sup>137</sup> See I.R.C. § 410(b) (West Supp. 1987).

<sup>138</sup> A plan satisfied pre-Tax Reform Act coverage rules if it benefited at least 70% of all employees or a percentage of eligible employees equalling at least 56% of all employees, see I.R.C. § 410(b)(1) (1982), amended by I.R.C. §§ 401(a)(26), 410(b)(1) (West Supp. 1987), or if it met the classification test as applied in Rev. Rul. 83-58, 1983-1 C.B. 95, such that there was a reasonable difference between the ratio of highly compensated and not highly compensated employees benefited. See I.R.C. § 410(b)(2) (1982) (permitting an employer to set up classifications, as long as the Secretary finds such classifications to be nondiscriminatory).

<sup>139</sup> See I.R.C. § 410(b)(1) (West Supp. 1987).

<sup>140</sup> See I.R.C. § 401(a)(26) (West Supp. 1987).

<sup>141</sup> Two examples are the exceptions for part-time employees, see I.R.C. § 410(b)(4) (West Supp. 1987), and employees covered by collective bargaining agreements, see I.R.C. § 410(b)(3) (West Supp. 1987).

ployers to integrate their pension plans with social security benefits.<sup>142</sup>

Prior to the Tax Reform Act of 1986, rules permitting integration of employer-provided plans with social security benefits allowed employers to limit pension benefits to employees whose earnings exceeded the social security wage ceiling.<sup>143</sup> The 1986 legislation simplifies the extraordinarily complex rules of prior law, attempts to increase employer contributions and benefits on behalf of low-wage earners, and eliminates the ability of employers to provide no benefits for low-wage earners but nevertheless qualify for favorable tax treatment.<sup>144</sup> The new integration rules, however, continue the prior practice of allowing employer plans to take into account the disproportionately larger benefits of Social Security for low- and moderate-income workers and thereby to provide disproportionately greater benefits to high-wage earners, so long as proportionate benefits are achieved in combination throughout the wage scale.<sup>145</sup> The basic concept of allowing integration of employer plans and Social Security is consistent with a unified view of retirement security policy. On the other hand, such a policy allows benefits under employer plans to reverse the progressive distribution of social security benefits and, even after the improvements of the 1986 legislation, fails to ensure a coherent structure of retirement benefits in terms of a sliding-scale-percentage wage-replacement goal that would provide greater proportional wage replacement for low- and moderate-income workers.

## 2. Distribution of Risks from Employer-Provided Plans

To structure a program of providing security for retiring workers that relies heavily on employer-provided pension plans necessarily requires a determination about the allocation of a variety of risks among employers, employees, and the government. There are a variety of rea-

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<sup>142</sup> Many plans meet the nondiscrimination standards only if the social security benefits and payments are taken into account as if they were pension benefits provided by an employer under a pension plan. See I.R.C. § 401(l) (West Supp. 1987).

<sup>143</sup> See I.R.C. § 401(l) (1982), amended by I.R.C. § 401(l) (West Supp. 1987).

<sup>144</sup> See I.R.C. § 401(a)(5) (West Supp. 1987).

<sup>145</sup> Although the 1986 Tax Reform Act reduces the percentage disparity allowed, see I.R.C. § 401(a) (West Supp. 1987), employees earning more than \$42,000 still can contribute a higher percentage of their annual income to a tax-advantaged pension plan. For example, under a defined contribution plan, the employer still can contribute at a rate of 10%, for compensation in excess of \$42,000, while contributing only 5% for compensation below \$42,000. Such a plan will be held not to be discriminatory in favor of highly paid individuals. See *id.*; see also N. Altman Lupu, *supra* note 2, at 61-69 (discussing how the "fiction" that Social Security involves payments into individual accounts is used to justify regressive benefit or contribution payments under qualified private pensions).

sons that an employer-provided plan ultimately might fail in reaching the ideal outcome of providing employees full replacement of preretirement wages when combined with social security.<sup>146</sup> As indicated above, such failures are often due to vesting requirements and limitations on portability of pension benefits that, in effect, require an employee to bear the risks of changing employers, whether as a result of events in the employee's life or due to economic factors affecting the employer.

Even for employees who spend their entire working lives with the same employer, however, the risk that their pensions will be inadequate is significant. For example, an employee may experience preretirement adversity and a concomitant need to withdraw funds from a pension plan; the investment earnings of the plan may be lower than anticipated; the employee's compensation may have increased to a higher level than expected; inflation both prior and subsequent to retirement may be greater than anticipated or (as is the case with most private plans) the plan may not provide for postretirement inflation; because of funding or earnings, the plan may have insufficient assets upon termination (either of the plan or of employment), and Pension Benefit Guarantee Corporation Insurance may or may not provide an adequate replacement; the employee may have to retire early; and, finally, the employee's service may have begun prior to the adoption of the employer's plan, and pre-adoption service may not be covered.<sup>147</sup>

A variety of specific provisions also affect the allocation of risks of employer-provided plans among employers, employees, and the government. These include the existence and scope of federal pension insurance benefits<sup>148</sup> as well as rules governing vesting<sup>149</sup> and portability.<sup>150</sup> Other factors affecting risk distribution include whether the plan is structured as a defined contribution or defined benefit plan, rules concerning termination of employer-provided plans, and rules establishing conditions and penalties for preretirement withdrawals of accumulated benefits. A discussion of these latter three issues will illuminate the

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<sup>146</sup> See Halperin, *supra* note 10, at 161 n.13, 168-71, 182-90.

<sup>147</sup> See generally *Overfunded Pension Plans*, *supra* note 111, at 127-34 (reprinting materials on plan terminations and asset reversions to employers, in appendix); Halperin, *supra* note 10 (discussing the security of benefits under defined benefit and defined contribution plans); N. Altman Lupu, *supra* note 2, at 40-49 (discussing a worker security proposal).

<sup>148</sup> See 29 U.S.C. §§ 1301-1309, 1321-1323, 1341-1348, 1361-1368, 1381-1461 (1982 & Supp. III 1985 & West Supp. 1987) (providing for a plan termination insurance program).

<sup>149</sup> See I.R.C. § 411 (1982 & West Supp. 1987); EBRI, *VESTING*, *supra* note 104, at 1-4.

<sup>150</sup> See I.R.C. §§ 402(a)(5), 403(a)(4), 408(d)(3) (1982 & Supp. III 1985 & West Supp. 1987) (permitting "rollover of benefits").

most important considerations.

Employer-sponsored pension plans are of two general types: defined benefit or defined contribution. A defined benefit plan determines retirement payments under a benefit formula that usually takes one of three types: (1) a flat-benefit formula, which pays a specific dollar amount for each year of service under the plan; (2) a career-average formula, which bases the benefit on a percentage of career-average pay, multiplied by the employee's years of service; or (3) a final-pay formula, which bases benefits on the employee's average earnings during a specified number of years immediately prior to retirement.<sup>151</sup> A defined contribution plan, in contrast, requires employers to pay a specific amount into the pension fund for each employee participant and ascribes the accumulation of payments and their investment earnings to each employee. Under a defined contribution plan, the employer's contributions are either a percentage of salary or, less often, of profits. The retirement benefits under such a plan will be determined based solely on the accumulated amount in the participant's account at retirement.<sup>152</sup> Defined benefit plans remain the dominant type of plan, but recent years have apparently produced a shift toward defined contribution plans.<sup>153</sup> This movement away from defined benefit plans raises the major policy question whether to adopt rules inhibiting such a trend, for example by providing greater inducements to defined benefit plans or imposing new restrictions on defined contribution plans.

Several factors are relevant in making such a policy decision. First, a defined benefit plan may be more precisely geared toward satisfying a specific-percentage wage-replacement goal for each employee than a defined contribution plan.<sup>154</sup> This means that under defined benefit plans employers bear most of the risks of unexpected patterns of compensation over time as well as the risks of investment performance. In addition, whenever benefits are based on final pay, the employer also bears the risk of unanticipated preretirement inflation, although the employee typically bears the risks of postretirement inflation. Second, defined benefit plans have historically taken into account employee service prior to institution of the plan, but defined contribution plans have

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<sup>151</sup> Z. BODIE, A. MARCUS & R. MERTON, *DEFINED BENEFIT VERSUS DEFINED CONTRIBUTION PENSION PLANS: WHAT ARE THE REAL TRADEOFFS?* 3-4 (National Bureau of Economic Research Working Paper No. 1719, 1985) [hereinafter *NBER Paper*].

<sup>152</sup> See *id.* at 2.

<sup>153</sup> See CONG. RESEARCH SERV., 99TH CONG., 1ST SESS., *PRIVATE PENSIONS PLANS: WHICH WAY ARE THEY HEADED?* 14 table 2 (Comm. Print 1985) [hereinafter *CRS*]; *FIRST DECADE*, *supra* note 85, at 116 table 3.

<sup>154</sup> See *CRS*, *supra* note 153, at 3.



not.<sup>155</sup> Third, defined contribution plans shift the risks of changes in real wages to employees and, in addition, require employees to bear investment risks.<sup>156</sup> Finally, while the stability of retirement benefits as a percentage of wage replacement is the major advantage claimed for defined benefit plans,<sup>157</sup> defined contribution plans typically offer employees a clearer picture of the value of their accumulating retirement benefits. Under a defined contribution plan, a participant may at any time readily ascertain the present value of the retirement assets accumulated in the plan on her behalf.<sup>158</sup> As the factors listed here suggest, it is inherently more difficult for an employee to determine the assets that will be available for retirement under a defined benefit plan. Not surprisingly, many retirees have discovered that their actual retirement benefits are substantially less than they had anticipated.

Rules concerning termination of employer-provided plans also affect the allocation of risks of such plans among employers, employees, and the government. The choice between defined benefit and defined contribution plans affects the ability of employers to capture benefits either by reducing future contributions or by terminating plans when their investment performance provides a funding level greater than the accrued liabilities under the plan. Greater than expected inflation in recent years has resulted in a number of defined benefit plans that have assets in excess of accrued liabilities.<sup>159</sup> For example, recent estimates indicate that 88% of defined benefit plans of Fortune 500 companies had assets greater than 1983 year-end liabilities and more than 34% of such plans had assets one and a half times as large as liabilities.<sup>160</sup> Under current law, these plans not only allow employers to use the excess investment returns to decrease future contributions to the plan, but they also present opportunities for termination.<sup>161</sup> If a plan is terminated, the employer typically will disband the trust fund and pay benefits to vested workers in a lump-sum distribution or, alternatively, will purchase retirement annuities for them. Any excess will be captured by the employer, who then must make a choice. The employer may refuse to establish a new plan, thereby declining to play any fu-

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<sup>155</sup> See *id.*

<sup>156</sup> See NBER Paper, *supra* note 151, at 4.

<sup>157</sup> See Halperin, *supra* note 10, at 183-85.

<sup>158</sup> See CRS, *supra* note 153, at 4 (noting the ease with which an employer can determine the pension obligation owed to the employee).

<sup>159</sup> See *Overfunded Pension Plans*, *supra* note 111, at 128-29.

<sup>160</sup> See *Personal Savings Down, Linked to Pension Funding, Study Finds*, J. ACCT., Feb. 1986, at 24 (discussing National Bureau of Economic Research Study No. 1622).

<sup>161</sup> See Stein, *Raiders of the Corporate Pension Plan: The Reversion of Excess Plan Assets to the Employer*, 5 AM. J. TAX POL'Y 117, 127-33 (1986).

ture role in its employees' retirement savings or, as is often the case, the employer may create a new plan.<sup>162</sup> Whichever option the employer chooses it is clear that defined benefit plans routinely have produced opportunities for employers to use pension funds as a means of accumulating investment income tax-free, without ensuring that stated retirement security goals or retirement benefits expected by their workers actually will be realized.

In sum, defined benefit plans, because of their direct connection to wage replacement, ostensibly seem better targeted to workers' retirement security concerns than defined contribution plans.<sup>163</sup> Without immediate vesting requirements and restrictions on plan terminations, however, defined benefit plans ultimately may disappoint employees' expectations for retirement pensions. Consequently, defined contribution plans may offer considerable advantages for many workers. Defined contribution plans also may encourage employers who otherwise would have no plan at all to establish at least a limited plan that, over time, may provide significant retirement savings for employees. So long as having a pension plan remains voluntary, retaining flexibility for employers to choose between defined benefit and defined contribution plans may prove to be an important element in inducing employers to maintain pension plans. Employers' preferences, of course, will depend upon their attitude about shifting or retaining wage and investment risks.

A final set of provisions affecting the allocation of risks of employer-provided plans are rules establishing conditions and penalties for preretirement withdrawals of accumulated benefits. In particular, the 1986 Act includes new limitations on the ability of employees to gain access to pension funds prior to retirement.<sup>164</sup> These provisions were adopted principally as a means of ensuring that tax advantages intended for retirement savings will be recaptured whenever such savings do not satisfy the retirement security goal.<sup>165</sup> New restrictions on borrowing against pension assets also were included in the 1986 legislation.<sup>166</sup> In both cases, Congress seemed to be concerned principally with

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<sup>162</sup> See *id.* at 129-30.

<sup>163</sup> See NBER Paper, *supra* note 151, at 13, 27; Wolk, *supra* note 23, at 422-24.

<sup>164</sup> The Act imposes tax penalties for most early distributions from qualified plans to recoup the initial tax advantage gained. With some exceptions, the Act applies an additional 10% income tax to all early distributions included in an employee's gross income. See I.R.C. § 72(t) (West Supp. 1987); see also EMPLOYEE BENEFIT RESEARCH INSTITUTE, ISSUE BRIEF NO. 59, TAX REFORM AND EMPLOYEE BENEFITS 18 (1986) [hereinafter EBRI, TAX REFORM].

<sup>165</sup> See 2 CONF. REP., *supra* note 34, at 457 (characterizing the additional tax as a recapture tax).

<sup>166</sup> The Act tightens the ability of participants to maintain a revolving, tax-de-

the tax abuse potential inherent in a regime that would erroneously allow preretirement withdrawals.

The withdrawal issue once again demonstrates the inherent difficulties of placing heavy reliance on a voluntary mechanism as a means of funding basic retirement security for workers. If employees believe that they must retain pension assets in the pension fund until retirement, regardless of any preretirement hardships they might experience, they may be quite reluctant to engage in this form of savings and will tend to prefer cash to deferred compensation, even at some tax cost. On the other hand, if free withdrawal from retirement savings plans were permitted without substantial penalty, it would be foolhardy for Congress to rely on such plans to provide workers with significant assets upon retirement. Moreover, the risks of long-term savings limited to retirement seem to bear disproportionately on low- and moderate-income workers who may be most concerned about access to such assets in times of emergency. The limitations on early withdrawals and loans contained in the 1986 Act reflect congressional compromises between these competing considerations.

From a retirement income security perspective alone, the danger inherent in preretirement withdrawals is self-evident. Loans from pension funds, however, seem less threatening than preretirement withdrawals or distributions. The worker at least has an obligation to return borrowed amounts to the retirement fund. This obligation, however, does not solve the problem, for loans may threaten significantly the retirement security goal of income tax expenditure provisions and undermine both tax policy and retirement policy objectives.<sup>167</sup> This limits the feasibility of the natural response of retirement security proponents: to enact tougher rules on preretirement withdrawals or distributions coupled with relatively liberal rules governing the ability of workers to borrow pension funds upon a showing of genuine hardship.<sup>168</sup> The problem of borrowing is considered further following a

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ductible loan from their qualified plan account by reducing the amount of the loan in the current year by the highest balance in the previous 12 months, limiting extended repayment periods for home loan purchases, and denying an interest deduction for loan repayment by key employees and § 401(k) plan contributors. See I.R.C. § 72(p) (West Supp. 1987); see also EBRI, *TAX REFORM*, *supra* note 164, at 18.

<sup>167</sup> See SENATE FINANCE COMM., *TAX REFORM ACT OF 1986*, S. REP. NO. 313, 99th Cong., 2d Sess. 639 (1986) [hereinafter *FINANCE COMM.*]; Halperin, *supra* note 10, at 182; *Finance Committee Considers Pension and Estate Issues*, 31 *TAX NOTES* 106, 107 (1986) (statement of Sen. Danforth identifying how interest-deduction tax incentives thwart retirement savings goals). For an extended discussion of this issue, see *infra* notes 204-09 and accompanying text.

<sup>168</sup> The 1986 Act provides substantial restrictions on early reversions and distributions of plan assets through tax penalties and rollover requirements that recoup the initial tax incentives for retirement savings. See, e.g., I.R.C. §§ 72(o) (additional tax

discussion of the income tax incentives for individual retirement savings.

#### IV. INDIVIDUAL SAVINGS FOR RETIREMENT

The third element of this nation's retirement income security program is individual savings. Necessarily, such savings will prove an effective source of retirement income only for those individuals who are able to save during their working lives or who have acquired investment assets from another source. The ability privately to save adequate retirement assets therefore will tend to be concentrated in the high-income classes.

As before, tax policy plays an important role. Because of the current taxation of investment income, an income tax has a natural tendency to favor current consumption as opposed to deferred consumption. In other words, an income tax is inherently less favorable toward savings than would be a consumption or wage tax.<sup>169</sup> Therefore, the reliance of the federal government on the individual income tax as an important source of revenues makes individual savings more costly than would be true if such revenues were raised through, for example, consumption taxation.<sup>170</sup> As a result, a variety of income tax preferences have been enacted over the years in an effort both to stimulate savings generally and to encourage either particular kinds of investments or savings for specified purposes.

Two categories of income tax incentives for individual savings are important here. First, this Article addresses individual savings incentives limited to retirement savings to determine their efficacy and to

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on early withdrawals of previously deductible employee contributions), 72(t) (additional tax on early withdrawals), 402(a) (rollover requirements), 402(e)(4)(B) (rules regarding lump sum distribution), 4974 (excise tax on certain accumulations), 4980 (tax on reversion of qualified plan assets to employer), 4981A (tax on excess distributions from qualified plans) (West Supp. 1987). The liberal definition of the circumstances that constitute a hardship for loan purposes is not changed from present law, but the maximum amount of money borrowed is limited. See I.R.C. § 72(p)(2)(A) (West Supp. 1987) (reducing \$50,000 limit by the balance of certain preceding loans); see also EBRI, TAX REFORM, *supra* note 164, at 18. Capping the amount of pension assets available to be borrowed and barring the loan's interest deductibility, while allowing loans for a wide variety of circumstances, encourages the middle-income earner to earmark contributions for retirement while providing a safety valve. The interest and loan amount restrictions discourage borrowing solely for tax arbitrage. See *infra* notes 204-09 and accompanying text.

<sup>169</sup> See E. STEUERLE, *supra* note 34, at 171-75; Halperin, *supra* note 59, at 523-24. For a more general discussion, see M. GRAETZ, *supra* note 28, at 20 and n.\* (compiling some of the leading articles on the issue).

<sup>170</sup> See sources cited *supra* note 169. See generally WHAT SHOULD BE TAXED: INCOME OR EXPENDITURES? (J. Pechman ed. 1980) (comparing effects of different tax systems).

ascertain their potential impact on tax incentives for employer-provided pension plans. This will be followed by a consideration of individual savings incentives that are not explicitly directed toward retirement savings, both to evaluate their potential impact on Congress's ability to impose conditions on incentives for retirement savings and to examine the extent to which savings not initially undertaken for retirement ultimately may prove an important source of income during retirement. Finally, the ways in which the ability to borrow undermines both retirement security and tax policy goals will be examined.

### A. *Income Tax Incentives for Retirement Savings*

The closest retirement savings analogue to employer-sponsored pension plans is the so-called Keogh Plans for self-employed persons.<sup>171</sup> Benefits analogous to those available to employees under qualified pension plans were made available to self-employed persons in 1962, but maximum benefits were far more restrictive. The maximum annual contribution was limited to \$2500 in 1962<sup>172</sup> and had been increased to only \$15,000 by 1982.<sup>173</sup> In contrast, pension benefits for employees were first subjected to a ceiling by ERISA in 1974.<sup>174</sup> The Tax Equity and Fiscal Responsibility Act of 1982 generally created parity between Keogh plans and qualified pension plans. The revenue loss for Keogh plans was estimated at \$2 billion in 1986.<sup>175</sup>

In recent years, the most important tax incentive for individual retirement savings has been the Individual Retirement Account. When the tax preference for IRAs was originally enacted in 1974, it provided an opportunity for tax-advantaged savings limited in amount and eligibility.<sup>176</sup> For example, persons could not qualify for the tax reduction if they were covered under an employer-sponsored pension plan. This re-

<sup>171</sup> For a general discussion of Keogh plans, see Lucas, *IRAs, SEPs and KEOGHs*, 18 AKRON L. REV. 609 (1985); Smith, *A Comment on IRAs and Keoghs*, 38 NAT'L TAX J. 111 (1985); Comment, *There Should Be Parity in Bankruptcy Between Keogh Plans and Other ERISA Plans*, 80 NW. U.L. REV. 165 (1985).

<sup>172</sup> See Self-Employed Individuals Tax Retirement Act of 1962, Pub. L. No. 87-792, § 3(b), 76 Stat. 809, 820 (1962).

<sup>173</sup> See I.R.C. § 404(e)(1) (1982), *repealed by* Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 238(a), 96 Stat. 304, 512.

<sup>174</sup> See I.R.C. § 415(b)(1) (1976), *amended by* I.R.C. § 415(b)(1) (West Supp. 1987) (limiting benefits under employer-sponsored plans to \$75,000); I.R.C. § 415(c)(1) (1976), *amended by* I.R.C. § 415(c)(1) (West Supp. 1987) (limiting contributions to \$25,000 annually). These maximums, when adjusted for inflation, *see* I.R.C. § 415(d) (1976), *amended by* I.R.C. § 415(d) (West Supp. 1987) (authorizing annual cost-of-living adjustments), were \$136,425 for benefits and \$45,475 for contributions by 1982. *See* M. GRAETZ, *supra* note 28, at 802.

<sup>175</sup> *See* EBRI, *IRAs*, *supra* note 20, at 2.

<sup>176</sup> *See* I.R.C. § 219(b) (1976), *amended by* I.R.C. § 219(b) (West Supp. 1987).

striction was, to some extent, an effort to be responsive to concerns expressed by organized labor, which opposed the IRA deduction because of fear that such a deduction would deter employers from establishing pension plans for employees.<sup>177</sup> In 1981, tax legislation dramatically expanded opportunities for IRAs by allowing all individuals identical tax savings. Up to \$2000 of annual earnings was permitted to be excluded from the income tax base through an immediate deduction. In addition, investment earnings on IRAs could be accumulated free of current income tax, with payments from the account during retirement includable in the recipient's income.<sup>178</sup>

The 1981 extension of IRA eligibility to all workers produced a revenue loss more than six times greater than that which was originally estimated.<sup>179</sup> At the end of 1981, IRA and Keogh assets totalled slightly more than \$38 billion; at the end of 1985, they amounted to \$224 billion.<sup>180</sup> Although the bulk of this revenue loss has been concentrated among high-earning employees, the mass marketing of IRAs by savings institutions apparently induced large numbers of middle-income taxpayers to shift away from general savings accounts, which are not eligible for tax savings, to tax-preferred retirement savings. At the end of 1982, people with less than \$20,000 of taxable income accounted for 14.6% of the total IRA deductions claimed on income tax returns, compared to 28.4% for people with over \$50,000 in taxable income.<sup>181</sup> Only 15.3% of people making between \$15,000 and \$20,000 had an IRA, compared to 59.7% of those earning \$50,000 or more.<sup>182</sup> The revenue loss from the IRA provisions was estimated to be \$12.5 billion in 1984.<sup>183</sup> It is worth noting, however, that, in this context, where eligibility for and use of IRAs was widespread, the relatively small \$2000 limit on annual IRA savings seems to have been quite significant in reducing the potential threat of IRAs to employer-provided plans. The \$2000 amount is not high enough (compared to maximum limitations on employer pension plans) to eliminate the desire of high- and middle-

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<sup>177</sup> See M. GRAETZ, *supra* note 28, at 803.

<sup>178</sup> See I.R.C. § 408 (1982) amended by I.R.C. § 408 (West Supp. 1987); see also 1 DEVELOPMENTS, *supra* note 74, at 100-02; EBRI, IRAS, *supra* note 20, at 4; Halperin, *supra* note 10, at 159-63.

<sup>179</sup> See 1 DEVELOPMENTS, *supra* note 74, at 101.

<sup>180</sup> See EBRI, IRAS, *supra* note 20, at 2, 5, 6-7.

<sup>181</sup> See *Proposals*, *supra* note 85, at 34.

<sup>182</sup> See EBRI, IRAS, *supra* note 20, at 8 table 3. Additionally, 46% of IRAs are held by employees with vested pension rights. See 1 DEVELOPMENTS, *supra* note 74, at 102.

<sup>183</sup> See EBRI, IRAS, *supra* note 20, at 13 table 10. For estimates of projected revenue losses from IRAs through 1992, see J.T. COMM. ESTIMATES, *supra* note 19, at 15.

income workers for the development and maintenance of employer-sponsored pension plans.

The 1986 Act once again restricted the ability to enjoy the full benefits of IRAs only to individuals not covered by employer plans. Under the 1986 legislation, single persons with more than \$25,000 of income and married couples with more than \$40,000 of income who are covered by employer plans are no longer eligible to deduct IRA contributions, but they may continue to receive tax-free accumulations of investment income both on their pre-1986 contributions to IRAs and with respect to additional annual IRA contributions of not more than \$2000 a year.<sup>184</sup> With this change, it has been estimated that, of the 24.4 million individuals who had opened an IRA prior to the Tax Reform Act, 15% or 3.7 million individuals would have lost the IRA deduction completely, 12% or 2.9 million individuals would have been eligible for a partial deduction, and 73% or 17.8 million would have been eligible for a full deduction had the Tax Reform Act been in effect.<sup>185</sup> The Senate Finance Committee estimated that the elimination of the deduction for IRA contributions for people covered by pension plans would raise \$25 billion of revenue over the fiscal years 1986-1991<sup>186</sup> and thereby contribute significantly to Congress's ability to lower income tax rates. Given the inaccuracy of prior estimates of people's behavior in response to IRA tax incentives, however, it is difficult to predict how many people will continue to establish or add to IRA accounts to take advantage of this more limited tax incentive or, alternatively, will begin or expand savings through other tax-preferred vehicles to retain the advantages that were available through IRAs under prior law.

Congress did not adopt the 1986 restrictions on IRAs in response to concerns about their potential impact on employer-provided pension plans. On the contrary, retirement security concerns were dwarfed by other fiscal policies. The politics of the 1986 tax reform bill required a reduction in the top income tax rates that absent massive and unacceptable revenue losses could be accomplished only by slashing a wide variety of tax incentives, including IRAs.<sup>187</sup> Congress's primary concern

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<sup>184</sup> See I.R.C. §§ 219, 408 (West Supp. 1987); see also EBRI, TAX REFORM, *supra* note 164, at 20. The new tax restrictions regarding IRAs are effective beginning with IRAs established after 1986 or post-1986 additions to existing IRAs. The Senate version of the 1986 Act would have eliminated deductible IRAs for all persons covered by an employer plan. See 2 CONF. REP., *supra* note 34, at 375-76.

<sup>185</sup> See EBRI, TAX REFORM, *supra* note 164, at 19.

<sup>186</sup> See FINANCE COMM., *supra* note 167, at 23 table III-2.

<sup>187</sup> See *id.* at 31 ("The committee bill broadens the base of the individual and corporate income taxes, principally for the purpose of reducing marginal tax rates.").

was that the long-term potential revenue loss from this increasingly popular retirement savings incentive would require significantly higher income tax rates than would be possible with the more limited incentive.<sup>188</sup> Congress also was aware of the evidence that the IRA provisions had not been particularly effective in stimulating overall national savings. Widely available IRAs apparently had instead induced a massive shift of general savings to IRAs.<sup>189</sup> From the perspective of retirement security policy, such a shift of savings may be desirable, even without any substantial increase in aggregate national savings.<sup>190</sup> The 1986 restrictions on income tax incentives for IRAs, however, demonstrate an important practical difficulty in relying heavily upon income tax incentives as a principal mechanism for implementing national retirement security policy: retirement security concerns often may be overridden by Congress's perceptions of more pressing fiscal policy needs.

Almost by accident, however, the IRA provisions are now structured quite nicely to serve retirement security goals. Tax benefits of the sort available to employer-provided pensions are available only to high-income employees if they are not covered by employer pension plans. In fact, for these workers, the \$2000 annual ceiling seems quite low compared to potential pension or Keogh benefits.<sup>191</sup> Other individuals covered by employer plans are allowed to earn tax-free investment income with respect to limited amounts of earnings annually put aside for retirement, but do not enjoy the benefit of excluding these amounts from

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<sup>188</sup> See *id.* at 4-5 (arguing that the tax treatment of IRAs is overly generous for individuals who participate in other tax-preferred retirement arrangements, namely high-income taxpayers, and thus results in "a direct erosion of the tax base, requiring higher tax rates").

The requirement of revenue neutrality in the 1986 legislation caused the direct linkage of tax rates and tax expenditures in the retirement savings context. This linkage has made indisputable the contention of tax expenditure critics that income tax reductions such as those effected by the Act ultimately must be paid for by higher taxes on those who do not benefit. The potential distributional consequences, therefore, of income tax incentives for retirement savings utilized predominately by higher income taxpayers call into question not only the fairness of such incentives themselves, but also of the routine practice of ignoring the existence of such incentives when assessing the overall fairness of our public retirement security policies.

<sup>189</sup> See FIRST DECADE, *supra* note 85, at 124-25.

<sup>190</sup> See *id.* at 126-127; see also 1 DEVELOPMENTS, *supra* note 74, at 106-07 (noting lack of increase in aggregate national savings).

<sup>191</sup> Under the Tax Reform Act, workers still can contribute relatively substantial amounts to Keogh plans (\$7000) or cash or deferred compensation arrangements ("CODAs") (\$7000) without subjecting themselves or their employers to the more stringent regulation of a qualified plan. See I.R.C. §§ 219(b) (Keogh plans); 402(g)(1) (CODAs) (West Supp. 1987); see also EBRI, IRAs, *supra* note 20, at 9 (rates of participation).



current income.<sup>192</sup>

Taxpayers, however, may employ two basic strategies that have the potential to undermine the retirement security advantages of the 1986 IRA revisions. First, they may attempt to retain (or in some cases even increase) the pre-1986 tax benefits of IRAs by shifting to other tax-deductible forms of retirement savings. Second, they may endeavor to achieve the post-1986 IRA benefits while avoiding the IRA restrictions limiting dollar amounts eligible for tax-free investment returns and restricting the tax-free investment build-up to savings for retirement. Alternative forms of tax-preferred savings, therefore, may undermine the efficacy of the 1986 limitations.

In addition to IRAs, there exist provisions that allow employees to make their own contributions to retirement savings plans in lieu of receiving cash salary and, by so doing, to achieve tax savings comparable to those available under the 1981-86 law for IRAs and currently available for employer contributions to employer-sponsored pension plans. The most important of these salary reduction plans are so-called section 401(k) plans, commonly known as cash or deferred arrangements (CODAs).<sup>193</sup> Even more generous optional salary reduction plans are available to employees of certain tax-exempt institutions under other sections of the Internal Revenue Code.<sup>194</sup> These plans are subject to a variety of constraints, along the lines of rules applicable to employer pension plan contributions, principally designed to allow employees opportunities for additional tax-preferred retirement savings so long as these opportunities are not limited to high earning employees.

From the perspective of national retirement security policy, the critical issue with respect to CODAs is whether, on balance, these tax preferences stimulate additional net increases to retirement savings by encouraging savings for retirement that would not otherwise occur or whether these plans serve as substitutes for employer contributions to pension plans that would discriminate less in favor of high earners.<sup>195</sup>

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<sup>192</sup> See I.R.C. § 408(o) (West Supp. 1987); see also FINANCE COMM., *supra* note 167, at 544.

<sup>193</sup> See I.R.C. § 401(k) (West Supp. 1987). For a discussion of the operation of § 401(k) plans, see generally Halperin, *supra* note 10.

<sup>194</sup> See I.R.C. § 403(b) (West Supp. 1987) (allowing annual contributions to tax-sheltered annuities); see also I.R.C. § 402(g)(4) (West Supp. 1987) (raising limit on such contributions from \$7000 to \$9500); I.R.C. § 457 (West Supp. 1987) (allowing government organizations to gain some tax advantages through the use of unfunded deferred compensation plans); I.R.C. § 501(c)(18) (West Supp. 1987) (allowing nongovernment tax-exempt organizations to establish pension plans that qualify for some tax advantages without requiring such plans to meet strict nondiscrimination standards).

<sup>195</sup> See Halperin, *supra* note 10, at 160-63; Wolk, *supra* note 23, at 429-34.

Without going into detail here, protection of the national retirement security system seems to demand that, to be eligible for tax-favored treatment, salary reduction plans should be required to satisfy nondiscrimination tests similar to those applicable to employer plans. In addition, the maximum savings under such plans should be substantially lower than that possible with respect to employer-provided retirement savings so that high-income employees will continue to have incentives to promote employer plans.<sup>196</sup> The 1986 legislation attempts to achieve both goals by tightening nondiscrimination requirements for CODAs and limiting the maximum annual elective deferral of compensation under such plans to \$7000 annually, including any amounts added to an IRA.<sup>197</sup> Where made available, however, salary reduction plans of-

<sup>196</sup> The following table estimates 1983 distribution of participants of pension plans, IRAs, and 401(k) plans by income class:

*Distribution of Pension, 401(k), and IRA  
Participants by Earnings*

Personal Earnings	Percent of All workers	Distribution of Pension Covered Workers <sup>a</sup> (percent)	Distribution of 401(k) Participants <sup>b</sup> (percent)	Distribution of IRA Participants <sup>c</sup> (percent)
Total	100.0%	100.0%	100.0%	100.0%
\$1-4,999	12.7	2.0	d.	5.8
\$5,000-9,999	19.0	9.2	4.8	9.8
\$10,000-14,999	21.9	21.3	14.8	14.6
\$15,000-19,999	16.0	21.0	18.4	16.3
\$20,000-24,999	12.6	18.8	18.5	14.8
\$25,000-29,999	6.8	10.2	13.6	11.4
\$30,000-49,999	8.5	13.5	22.4	19.2
\$50,000 and over	2.5	3.9	6.8	8.0

a. Data for 1983 pension coverage. Coverage is defined as 1983 employment in a pension-covered job. Workers who did not meet ERISA standards for participation in 1983 (i.e., part-time or part-year workers and workers under age 25) may not have been eligible to participate in pension plans.

b. 401(k) plan participation in 1983 among private-sector workers. Data exclude 401(k) and 403(b) plan participation among public-sector workers.

c. IRA participation in tax year 1982.

d. Number too small to be calculated reliably.

Source: EBRI, IRAs, *supra* note 20, at 9 table 5 (figures taken from EBRI tabulation in the May 1983 *EBRI/Department of Health and Human Services, Current Population Survey* pension supplement).

<sup>197</sup> See I.R.C. § 402(g) (West Supp. 1987); see also EBRI, *TAX REFORM*, *supra* note 164, at 22 (discussing new limitations on deferred compensation arrangements).

The 1986 legislation seeks to assimilate the role of individual retirement savings into a unified retirement security policy in a variety of other provisions as well. Tax-deferred annuity plans offered by charitable organizations, public schools, colleges, or universities, for example, also are brought more closely into conformity with qualified employer-provided pension plans with respect to coverage, nondiscrimination, withdrawal, and distribution provisions. A special annual \$9500 contribution limit is also included. See I.R.C. § 402(g) (West Supp. 1987). These new limits are substantially

fer employees opportunities for discretionary tax-preferred retirement savings in excess of the pre-1986 IRA limits. These opportunities may create a significant potential for employees to avoid the cutbacks in IRA deductions of the 1986 legislation.<sup>198</sup>

Despite these potential gaps, the Tax Reform Act of 1986 reflects a major effort to rationalize the rules governing employer-provided pension plans, IRAs, and salary reduction plans through an independent assessment of these programs in terms either of tax policy or retirement security policy. Further, by limiting availability of IRAs and maximum deductible employee contributions to salary reduction plans, the 1986 legislation should provide some protection for employer-provided pension plans from accelerating encroachment by more individualized retirement savings vehicles. This protection should strengthen the relationships among the alternative arrangements for tax-preferred retirement savings from the perspective of a unified retirement security policy. As noted, however, the efficacy of these retirement savings incentives, both as an independent stimulus to retirement savings and as a

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lower than the new maximum annual deductions available under qualified employer-provided pension plans. For example, under defined contribution plans the 1986 Act provides a maximum annual contribution of \$30,000, to be adjusted in subsequent years for inflation. See EBRI, *TAX REFORM*, *supra* note 164, at 22 (comparing prior limits and the Tax Reform Act changes). The 1986 Act changes with respect to salary reduction plans also exemplify the tendency toward a national retirement security policy. These changes were intended to rationalize better the relationship between IRAs, salary reduction plans, and employer-sponsored pension plans and to inhibit further trends in the direction of substituting salary reduction plans for pension coverage.

<sup>198</sup> Other opportunities to avoid these cutbacks in IRA deductions continue to exist. In some cases, for example, high-income earners may opt for so-called nonqualified forms of deferred compensation. In practice, however, these arrangements tend to be limited to certain types of high-income employees or to employees of closely held companies. Nonqualified deferred compensation does not explicitly enjoy tax savings comparable to that available with a qualified plan. For example, tax deferral on contributions is available with nonqualified plans, but tax-free interest build-up is not. Since these plans are not formally funded by the employer, the employee takes some risk by relying on the credit of the employer in order to defer tax on a portion of compensation. See Halperin, *supra* note 10, at 188-90. Nonqualified deferred compensation may, however, allow high earning employees to achieve some tax savings without becoming subject to the regulatory requirements applicable to qualified plans.

In addition, stock options from time to time have enjoyed tax preferred treatment and sometimes may have served as a substitute for savings through qualified pension plans for a limited number of high earners. See The Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 251(a), 95 Stat. 172, 256 (1981) (current version at I.R.C. § 422A(a) (1982 & West Supp. 1987)) (providing special tax treatment of employee incentive stock options). Such options are not taxable at the time they are granted or exercised, and the employee receives capital gains treatment on the sale of the stock. See M. GRAETZ, *supra* note 28, at 808. Although these stock options will be less attractive given the repeal of capital gains treatment, *see* Tax Reform Act of 1986, Pub. L. No. 99-514, § 301(a), 100 Stat. 2085 (1986) (repealing I.R.C. § 1202 (1982)); I.R.C. § 422A(a) (1982 & West Supp. 1987) (incentive stock options), eligible high income employees can still defer part of their taxable income through this method.

complement to social security and employer-provided pensions, may also depend on (1) whether there are other less restrictive tax-favored means of savings that could constrict the desirability either of IRAs or salary reduction plans for middle- and high-income workers, and (2) the extent to which opportunities to borrow to fund such tax-preferred retirement savings plans potentially undermine the entire tax expenditure structure.

### B. *Income Tax Incentives for Other Savings*

As the next step in this examination of income tax provisions implementing national retirement security policy, this Article will consider a few options for tax-preferred individual savings that are not restricted to savings for retirement. The existence of tax-preferred savings opportunities not explicitly directed toward retirement may serve to enhance the total amount of individual savings during a person's working years and thus may stimulate a greater amount of savings available for spending during retirement than otherwise would have been the case. On the other hand, the existence of opportunities for tax-preferred savings not directed toward retirement—by allowing taxpayers equivalent tax reductions through less restrictive alternatives—may inhibit the ability of Congress to fashion those restrictions on tax-preferred retirement savings that would best serve national retirement security policy. This potential deflection of savings may affect employer-sponsored plans as well as individual retirement savings. Income tax preferences for state and local bond interest, home ownership, and life insurance illustrate this tension.

A detailed look at these tax preferences for savings is outside the scope of this Article. Suffice it to say, all three enjoy significant tax advantages. Interest income on bonds issued by state and local governments is exempt from income tax,<sup>199</sup> and, where the interest differential between taxable and tax-exempt bonds of comparable risk is small,<sup>200</sup> this exemption affords a tax-free investment return similar to that available to post-1986 IRA contributions, with much greater liquidity and without dollar limitations. By the same token, all of the real and imputed income from owner-occupied housing (the returns to equity and the annual rental value) is, in effect, tax exempt, and deductions for interest and property taxes may produce a negative tax on income

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<sup>199</sup> See I.R.C. §§ 103, 141-150 (West Supp. 1987).

<sup>200</sup> As of March 31, 1987, for example, yields on 20-year tax-exempt bonds were approximately 94% of yields on 20-year Treasury bonds. See Wall St. J., Mar. 31, 1987, at 24, col. 2 (tax-exempt bonds), 35, col. 2 (Treasury bonds).

from owner-occupied housing.<sup>201</sup> Similarly, the exemption from current taxation of investment income earned by individuals in connection with reserves on savings through life insurance products offers a widely available means of tax-free savings, not limited in amount.<sup>202</sup>

Options to save through investments in tax-exempt bonds, home ownership, or life insurance, therefore, may offer individuals significant opportunities to achieve tax reductions comparable to those available after 1986 to individual retirement savings accounts, but without subjecting them to the retirement savings restrictions. There are no maximum limitations on the annual investments eligible for such benefits and no restrictions on the time at which funds may be withdrawn from such savings. While, unlike employer pension plans, these savings preferences are available only for after-tax amounts, there are no delays in vesting of benefits, no risks of plan termination by the employer, no loss of benefits when one changes employers, and no nondiscrimination requirements that demand substantially equal treatment for other individuals.

The ability to save through such vehicles as state and local bonds, home ownership, and life insurance free from the burdens of income taxation should serve to enhance the amounts of overall individual savings of high-income individuals who have discretionary income available for such savings during their working years. It is unclear, however, from the point of view of national retirement security policy, whether this advantage outweighs the potential effects of the less restrictive tax-preferred alternative savings opportunities in reducing pressures from high-income employees for the establishment and maintenance of private pension plans and in lowering the status of IRAs and salary reduction plans on high-earning employees' lists of savings priorities. Even after the base broadening changes of the 1986 Tax Reform Act, the continued vitality of such nonretirement savings incentives in the income tax seems assured. While this should ease policymakers' concerns about the need to provide new tax preferences to ensure that high-income individuals have tax-preferred opportunities to save as a means of achieving lifestyle maintenance during their retirement, it also serves to limit significantly the potential efficacy of severely restricting opportunities for high income individuals to enjoy tax-preferred savings

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<sup>201</sup> The estimated revenue loss from the deductibility of mortgage interest on owner-occupied homes was \$27.1 billion in 1986 and is projected to rise from \$33 billion in 1987 to \$51.5 billion in 1991. Revenue loss from the deductibility of property tax is estimated to reach \$9.6 billion in 1987, increasing to \$16 billion in 1991. See TAX EXPENDITURES, *supra* note 21, at 155, 159; see also E. STEUERLE, *supra* note 34, at 70-71 (noting possibility of achieving a negative tax).

<sup>202</sup> See E. STEUERLE, *supra* note 34, at 72-73.

for retirement.

The continued existence of tax preferences for nonretirement savings, at a minimum, emphasizes the importance of directing incentives for creating and maintaining retirement pension plans at employers rather than relying principally on exhortations from middle- and high-income employees as a stimulus to such plans. Such nonretirement income tax savings incentives also make apparent the risks inherent in relying predominantly on income tax incentives as a means of implementing national retirement security policy, risks that seem even greater when the possibility of borrowing is taken into account.

### C. *Effects of Borrowing on Tax Expenditures for Retirement Savings*

In recent years, tax analysts have offered analyses of the relationships between borrowing and tax incentives.<sup>203</sup> A phenomenon labeled "tax arbitrage" has been identified from the practice of borrowing and subsequently making deductible interest payments to purchase or carry assets that produce tax-preferred income.<sup>204</sup> Although there have been numerous studies of this phenomenon in recent years, there remains considerable dispute over the effect of tax arbitrage on the equity and efficiency of tax expenditures.<sup>205</sup> The impact of coupling borrowing and tax-preferred assets varies depending on whether the tax preferences have the effect of reducing the pretax rate of return on the tax-preferred asset. Borrowing to purchase or carry tax-exempt state and local bonds is exemplary.<sup>206</sup> A second type of tax arbitrage, labeled by Eugene Steuerle as "pure tax arbitrage," occurs when taxpayers are able to borrow to purchase or carry tax-preferred assets whose pretax rate of return has not been reduced. The retirement security tax preferences offer important opportunities for pure tax arbitrage.<sup>207</sup> Such opportunities may both defeat the retirement security goals of the income tax expenditures for retirement savings and undermine distributional goals of tax policy. An example demonstrates this point.

Assume that an individual borrows money from a bank and depos-

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<sup>203</sup> See, e.g., *id.* at 57-80; Steuerle, *Tax Arbitrage, Inflation, and the Taxation of Interest Payments and Receipts*, 30 WAYNE L. REV. 991 (1984); Warren, *Accelerated Capital Recovery, Debt, and Tax Arbitrage*, 38 TAX LAW. 549 (1985).

<sup>204</sup> See E. STEUERLE, *supra* note 34, at 59.

<sup>205</sup> See, e.g., *Savings and Retirement Proposals: Hearing Before the Senate Comm. on Finance*, 97 Cong., 1st Sess. 65-68 (1982) (statement of J. Chapoton) (deferred annuities must be reformed to reduce tax arbitrage); E. STEUERLE, *supra* note 34, at 61-77; Warren, *supra* note 203, at 568-74.

<sup>206</sup> See E. STEUERLE, *supra* note 34, at 72.

<sup>207</sup> See *id.* at 60-61. See also Andrews & Bradford, *supra* note 85.

its the money in an IRA either with the same bank or another bank. For simplicity, assume that the interest paid on borrowing is identical to that earned by the IRA, say 8%. The taxpayer will achieve an overall tax reduction by deducting the interest payment on the borrowing, while excluding or deferring from taxation the IRA receipts. Note that in this case there has been no increase in savings either by the individual or in the aggregate. Liabilities and assets have increased by an equal amount both in the economy and for the individual. A taxpayer in the 28% bracket who could engage in \$10,000 of borrowing and asset transactions would save \$224 in tax even though she did not add anything to her net savings. This \$224 tax savings is identical to what would have occurred if that taxpayer had put \$10,000 of new savings in an account that earned a tax-exempt 8%. This means that the full tax reduction designed to stimulate retirement savings may be available to taxpayers who can borrow even though no additional net savings have been made available either to the economy generally or to the individual for spending during retirement.

Borrowing to purchase pension assets, salary reduction assets, IRAs, and life insurance all may offer opportunities for the pure tax arbitrage described in the preceding example. The tax and savings effects described above will occur whether the individual borrows directly from the tax-preferred assets or, alternatively, whether the taxpayer borrows from an unrelated lender. This means that limitations on borrowing from IRAs, salary reduction plans, or pension funds will be effective, at most, in precluding pure tax arbitrage only for those taxpayers who do not have other borrowing sources.

The Tax Reform Act of 1986 suggests the first steps towards limiting the potential amounts of tax arbitrage. For example, the Act reduces the maximum amount of annual tax-preferred retirement savings, constricts taxpayers' abilities to borrow from retirement savings assets, and limits the deductibility of interest in connection with borrowing to purchase or carry tax-preferred retirement security assets.<sup>208</sup> In combination, these restrictions should inhibit the aggregate ability of taxpayers to undermine retirement security policies by engaging in borrowing transactions. They do not, however, eliminate all opportunities for pure tax arbitrage. Such opportunities will remain available, for example, for those individuals who can use home equity loans to bor-

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<sup>208</sup> See I.R.C. §§ 67, 163 (West Supp. 1987) (preserving ability to deduct interest payments on home mortgages and, consequently, allowing for tax arbitrage); *see also* EBRI, TAX REFORM, *supra* note 164, at 14-18 (discussing changes in contributions to and distributions from qualified plans).

row without losing the advantage of interest deductibility.<sup>209</sup> The restrictions on tax arbitrage will likely have the greatest effect on those taxpayers whose ability to borrow is constrained. This means that low- and moderate-income individuals, who may be unable to borrow additional amounts in a manner that produces deductible interest payments, will be eligible for the income tax expenditures directed to retirement savings only if they actually increase net savings for retirement. On the other hand, high-income taxpayers may continue to have arbitrage opportunities that will enable them to take full advantage of the retirement security income tax preferences without adding at all to their retirement savings. This state of affairs not only raises additional questions about both the fairness and efficacy of relying on income tax preferences for retirement savings as a major element of our national retirement security policy—particularly given the reliance of the current system on high-income level employees to stimulate employer plans—but also further skews the distribution of the income tax advantages in the direction of high earners.

### CONCLUSION

Analyzing social security and income tax preferences for employer-sponsored pension plans and individual retirement savings as a comprehensive retirement security package calls into question much of the common wisdom regarding our national retirement security program.<sup>210</sup> The income tax benefits that are skewed in the direction of high-income individuals render inexcusable the dramatic regressivity of the payroll tax to finance social security. A floor to exempt low-income workers from social security tax burdens, at least once a minimum number of quarters to ensure benefits has been accumulated, would be a significant improvement in the fairness of the payroll tax. The earned income tax credit of the income tax remains inadequate to this task, even after its 1986 expansion. When the distribution of income tax benefits for private retirement savings are taken into account, the payroll tax ceiling that reduces the burden of the wage tax for the less than 5% of employees with wages in excess of \$43,000 also becomes indefen-

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<sup>209</sup> See I.R.C. §§ 67, 163 (West Supp. 1987). The ability to deduct interest payments on home mortgages leads to the tax-induced behavior discussed above. See *supra* note 201 and accompanying text.

<sup>210</sup> For an example of a more positive judgment regarding the appropriateness of tax expenditures for private pensions that fails to reflect such a comprehensive view, see Graetz & McDowell, *Tax Reform 1985: The Quest for a Fairer, More Efficient and Simpler Income Tax*, 3 YALE L. & POL'Y REV 5, 15 (1984). In addition, the comprehensive analysis suggested here calls into question the usefulness of making inquiries such as that contained in Boskin, Kotlikoff, Puffert, & Shoven, *supra* note 2, at 26-27.



sible. Income tax-favored benefits for retirement, as well as other savings vehicles that favor high-level wage earners, are sufficiently great so as to obviate serious consideration of arguments that the elimination of the payroll tax ceiling would require an extraordinary increase in the maximum social security benefit.

The income tax contains massive tax benefits intended to stimulate voluntary employer-sponsored pension plans and discretionary individual savings for retirement. These massive subsidies can be justified only because Social Security provides an inadequate level of wage replacement for workers in all income classes. The analysis of this Article, however, demonstrates that reliance on tax expenditures for voluntary employer and individual retirement savings plans is highly questionable as a means of furthering national retirement security policy. The tax expenditure mechanism is naturally skewed in favor of high-earners, and it is not at all clear that even substantial tightening of the conditions necessary to obtain such tax benefits, such as were contained in both the 1974 and 1986 legislation, will be sufficient to guarantee a distribution of benefits that is fair to the low- and moderate-income workers who should have first claim on public subsidies for retirement savings. The ability to ensure a fair distribution of benefits is constrained by the voluntariness of the system, by the necessary prospect that the details of retirement security income tax expenditures will be held hostage to overriding fiscal or tax policy concerns, and by the use of tax planning—particularly borrowing in this instance—to undermine public policy goals.

The analysis in this Article thus raises the significant question whether there exists any alternative to extension of mandatory retirement security provisions as a means of ensuring both a fair distribution of public benefits and adequate retirement income for retirees in all income classes. The massive re-examinations of the income tax expenditures for employer-sponsored pension plans and individual retirement accounts in 1974 and again in 1986 imply that, although Congress is willing to go quite far in an effort to ensure some distribution of benefits to low- and moderate-wage earners, tax expenditures to continue the private pension system seem to have become politically untouchable. Even the prospect of the 20% or more overall reduction in income tax rates that might be obtained by repealing these tax expenditures does not seem sufficient to generate their demise. The restructuring of the IRA provisions in order to cap the top effective income tax rate at a percentage lower than 30% seems to be as far as Congress is willing to go. At the same time, current political attitudes are moving the economy in the direction of less, rather than more, regulation, and a new

requirement of mandatory employer-sponsored pension plans does not seem politically realistic. Thus, as a practical matter, the pressing question is whether a better compromise can be achieved.

Without a basic change in the present structure, there seems to be little hope for genuine retirement income security for moderate-income employees. Great improvement might be possible by imposing a flat income tax rate of, say, 10% on the investment income of pension funds or, alternatively, imposing an excise tax similar to that now imposed on assets of private foundations equal to, say, 2% of total assets contained in pension funds, salary reduction accounts, and IRAs, and using and adding the proceeds of such a tax to the trust fund for Social Security. Given the almost \$1 trillion of assets currently held in pension funds, Keogh plans, and individual retirement accounts,<sup>211</sup> a 2% excise tax on these assets would produce about \$20 billion of revenues. These revenues, in combination with the elimination of the payroll tax wage ceiling recommended above, could be used to provide current payroll tax relief to the working poor and to provide funds that would move significantly in the direction of 100% wage replacement for low- and moderate-income retirees. At the same time, the opportunities for higher income individuals to save through both employer-sponsored plans and tax-favored discretionary savings would continue.

Whether or not a substantial change of this sort is taken, greater attention must be given to tightening opportunities for tax savings in the absence of any significant retirement savings. In this connection, the problems that arise from coupling tax-preferred retirement savings with borrowing must be considered further in an effort to limit tax preferences for retirement savings to those instances where an actual net addition to retirement savings actually occurs.

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<sup>211</sup> By the end of 1985, total assets held in IRA and Keogh Accounts were estimated to be \$222.4 billion. See EBRI, IRAs, *supra* note 20, at 7 chart 3. By the end of 1980, total assets held by private pensions had risen to over \$400 billion. See A. MURNELL, *supra* note 4, at 62.